2018 African Economic Outlook

# Ethiopia

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- **Real GDP growth recovered to 10.9% in FY 2016/17[1] from 8.0% the previous year and is projected to remain strong at 8.1% and 7.8% for FY 2017/18 and FY 2018/19, respectively.**
- **Protests continued in 2017 and early 2018 mainly in the Oromia and Amhara regions demanding major reforms. The then Prime Minister resigned and the Government declared a state of emergency in February 2018 to facilitate the implementation of reforms to maintain peace and stability.**
- **Ethiopia's national development plans place emphasis on infrastructure development as a key enabler of economic structural transformation. However, ensuring sustainable infrastructure financing remains a challenge.**

## OVERVIEW

Real GDP increased by 10.9% in 2016/17 from the 8.0% registered in 2015/16. The industry and services sectors continued to drive growth. Agriculture recovered from the *El Niño* induced drought as it grew by 6.7% in 2016/17 compared to 2.3% in 2015/16. Growth is projected to remain buoyant in 2017/18 and 2018/19, due to investments in energy, transport, and logistics, and the ongoing reforms to bolster industrialization, particularly through the development of industrial parks; and continued progress in services. Agriculture will benefit from productivity enhancing investments, including irrigation.

Headline inflation in 2016/17 was in line with the single digit inflation objective of the central bank, the National Bank of Ethiopia (NBE) (Table 1). The NBE is currently implementing a contractionary monetary policy to address inflationary pressures that emerged during the second half of 2017. The budget deficit in 2017/18 is expected to increase by 0.2 percentage points from 2016/17 and is projected to rise further until 2020. Phased implementation of import-intensive public infrastructure projects, as the Government seeks to stabilize the public debt, will further lessen the current account deficit. Fluctuations in commodity prices remain key downside risks.

Ethiopia's Growth and Transformation Plans I and II (GTP II and I) both identify infrastructure as a key driver of structural transformation, leading to the prioritization of public infrastructure spending. However, according to Ethiopia's score on the Global Competitiveness Index (GCI), the infrastructure pillar has remained low. At 2.7 (on a scale of 1 to 7 with 7 being the best), Ethiopia's score in 2017/18 was below the Sub-Saharan African average (2.9). Ethiopia has relied on both concessional debt, particularly external loans from multilateral partners and official bilateral creditors, and commercial loans from non-traditional creditors such as China to finance its infrastructure projects. Reliance on external borrowing is not sustainable, especially given Ethiopia's high risk of external debt distress. Consequently, ensuring sustainability of infrastructure financing requires innovative solutions, such as use of Public-Private Partnerships (PPPs), securitization of infrastructure assets, and implementation of cost reflective tariffs.

1. Ethiopia's fiscal year runs from July 8 to July 7.

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**TABLE 1.** Macroeconomic indicators

| | 2016/17 | 2017/18(e) | 2018/19(p) | 2019/20(p) |
|---|---|---|---|---|
| Real GDP growth | 10.2 | 8.1 | 7.8 | 7.5 |
| Real GDP per capita growth | 7.5 | 5.5 | 5.3 | 5.0 |
| CPI inflation | 7.8 | 8.1 | 7.7 | 7.5 |
| Budget balance (% of GDP) | -3.3 | -3.5 | -3.7 | -3.8 |
| Current account (% of GDP) | -8.1 | -8.5 | -8.8 | -8.7 |

Source. Data from domestic authorities; estimates (e) and predictions (p) are based on the authors' calculations.

## RECENT DEVELOPMENTS AND PROSPECTS

Real GDP grew by 10.9% in 2016/17, up from the 8.0% growth registered in 2015/16. The industrial and services sectors contributed significantly to GDP growth by expanding at a rapid rate of 18.7% and 10.3% respectively. Construction, manufacturing, and electricity sub-sectors were the most important contributors to faster growth of the industrial sector, and grew respectively by 20.7%, 17.4%, and 11.4% in 2016/17 (compared to 25%, 18.4%, and 15% in 2015/16). Construction benefitted from public infrastructure investment, notably in transport, energy, water and sanitation. Investments in industrial parks contributed to steady growth in manufacturing. Strong growth in Foreign Direct Investment (FDI), particularly in infrastructure and manufacturing, also increased industrial sector value added.

The services sector, the leading contributor to real GDP, grew at 10.3% in 2016/17 compared to 8.6% the previous year. Trade, transport and communications, public administration, and real estate led growth in the services sector, which accounted for the largest share of GDP (Table 2). Financial intermediation, hotels and restaurants also supported growth in the services sector, although their contribution was largely unchanged in 2015/16 and 2016/17.

The rain dependent agricultural sector continued to recover from the 2015/16 *El Niño* induced drought, growing at 6.7% in 2016/17 compared with 2.3% growth the previous year. Productivity-enhancing investments such as irrigation and improved rainfall in the major Meher season (May–September) increased crop production and agricultural sector growth.

Merchandise export revenues recovered, increasing by 1.4% in 2016/17 to USD 2.91 billion from the 5% decline in 2015/16. This recovery was due to higher receipts from key exports, namely electricity (133%), coffee (22.2%), pulses (20.4%), fruits (4.5%), and *chat* (4%). However, declines in receipts for oilseeds (-26.4%), live animals (-54.3%), gold (-1.8%), and flowers (-3%) dampened the rebound in merchandise exports. Coffee, oil seeds, and pulses were the leading exports in 2016/17 and accounted for 52% of total exports, up from 50% the previous year.

The value of merchandise imports decreased by 5.5% in 2016/17 to USD 15.8 billion due to a decline in import volumes of major import items (capital goods by -11.7%, semi-finished products by -9.5%, raw materials by -15.9% and consumer goods by -7%). This reduction is consistent with the phased implementation of public infrastructure investments as the Government aims to stabilize the public debt. The share of fuel in total imports increased to 11.5% in 2016/17, 3.5% points higher than the previous year, partly due to rising fuel prices. Consequently, while still in double digits, the trade deficit has decreased steadily since 2014/15 (Table 4).

Private transfers are a significant source of foreign exchange, despite the decrease of net private transfers to USD 5.5 billion in 2016/17 from USD 6.4 billion in 2015/16. Remittances remained largely unchanged at USD 4.4 billion. The deficit on net services decreased to USD 546.9 million in 2016/17 from USD 619 million the previous year. Thus, the current account deficit, including transfers, slightly improved, but remains high due to the persistent deficits in merchandise trade and services. The overall balance of payments registered a surplus of USD 658.6 million (0.9% of GDP) in 2016/17 from a deficit of USD 830.9 million in 2015/16, with the surplus on capital account offsetting the current account deficit as a result of strong growth in FDI. FDI expanded by 27.6% to USD 4.17 billion in 2016/17 compared to the previous year. However, gross official reserves remained low at 2.5 months of import cover in 2016/17.

The negative impact of weather fluctuations on the country's rain-fed agriculture sector and uncertainty in commodity prices are the primary downside risks. Structural reforms to improve

**TABLE 2.** GDP by sector (percentage of GDP)

| | 2011/12 | 2016/17 |
|---|---|---|
| Agriculture, forestry, fishing and hunting | 44.7 | 36.3 |
| of which fishing | 0.0 | 0.1 |
| Mining and quarrying | 1.4 | 0.3 |
| of which oil | – | – |
| Manufacturing | 4.0 | 6.4 |
| Electricity, gas and water | 1.0 | 0.8 |
| Construction | 4.0 | 18.2 |
| Wholesale and retail trade; repair of vehicles; household goods; restaurants and hotels | 18.5 | 15.7 |
| of which restaurants and hotels | 3.6 | 2.1 |
| Transport, storage and communication | 4.2 | 4.9 |
| Finance, real estate and business services | 11.1 | 7.9 |
| Public administration and defence, security | 5.4 | 4.9 |
| Other services | 5.7 | 5.9 |
| Gross domestic product at basic prices / factor cost | 100.0 | 100.0 |

* Other services include education, health and social work and other services.
Source. Data from domestic authorities.

export competitiveness and diversification are under way. The development of industrial parks across the country and investments in energy, transport, and logistics infrastructure should increase manufacturing exports. Real GDP growth will remain strong at 8.1% and 7.8% in 2017/18 and 2018/19 respectively, consistent with the Government's phased implementation of public infrastructure projects to stabilize the public debt.

## MACROECONOMIC POLICY

### Fiscal policy

The Government pursued a prudent fiscal policy with emphasis on allocating spending to sectors with strong potential for poverty reduction and growth, such as education, health, agriculture, and infrastructure. This is in line with GTP II objectives, to create an enabling environment for boosting high value added production and private investment growth.

Government expenditure, as a share of GDP, has declined slightly since 2010 and remained stable. In line with the medium-term expenditure plan, sectors with high potential for poverty reduction and growth account for the largest share of the budget, although this share decreased to 62% in 2016/17 from 70% in 2013/14. The rise in current spending (Table 3) also reflects the increased allocation to the poverty reduction sectors. Capital spending constitutes a large share of general Government spending, accounting for 46.4% in 2016/17, but this share decreased from 59% in 2012/13, consistent with the phased implementation of import-intensive public infrastructure investments.

Tax revenues increased in absolute terms by 10.8% in 2016/17 compared to the previous year, enabling the Government to finance about 75% of its spending from domestic resources. However, the share of taxes as a percent of GDP has continued to decline since 2014/15. Key revenue-enhancing measures implemented in 2016/17 included the establishment of a directorate at the Ministry of Finance and Economic Cooperation (MoFEC) to spearhead tax policy, proclamations to improve income tax and tax administration, and revision of presumptive tax schemes to broaden the tax base. These measures are expected to complement previous reforms, such as improvements in customs processes and trade facilitation to increase the tax/GDP ratio, which at 11.6% of GDP in 2016/17 remains below the 2016 tax/GDP ratio of 15% in a median Sub-Saharan African economy. There are plans to revise the excise tax and VAT legislation in 2018/19 to support revenue mobilization. Prudent expenditure policy and an increased revenue mobilization effort will help to lower the budget deficit (Table 3).

| **TABLE 3.** Public finances (percentage of GDP) | 2009/10 | 2014/15 | 2015/16 | 2016/17 | 2017/18(e) | 2018/19(p) | 2019/20(p) |
|---|---|---|---|---|---|---|---|
| **Total revenue and grants** | 17.8 | 15.9 | 15.9 | 14.9 | 14.9 | 14.7 | 14.4 |
| Tax revenue | 11.6 | 13.2 | 12.4 | 11.6 | 11.4 | 11.4 | 11.3 |
| Grants | 3.3 | 1.0 | 0.8 | 0.7 | 0.9 | 0.8 | 0.7 |
| **Total expenditure and net lending** | 19.5 | 17.9 | 18.2 | 18.2 | 18.4 | 18.4 | 18.2 |
| Current expenditure | 8.7 | 8.6 | 8.9 | 9.8 | 9.8 | 9.8 | 9.7 |
| Excluding interest | 8.3 | 8.1 | 8.4 | 9.3 | 9.3 | 9.2 | 9.1 |
| Wages and salaries | 3.9 | 4.3 | 4.5 | 4.7 | 4.6 | 4.5 | 4.4 |
| Interest | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 0.6 |
| Capital expenditure | 10.8 | 9.4 | 9.4 | 8.5 | 8.6 | 8.7 | 8.5 |
| **Primary balance** | -1.3 | -1.6 | -1.9 | -2.9 | -3.0 | -3.2 | -3.2 |
| **Overall balance** | -1.7 | -2.0 | -2.3 | -3.3 | -3.5 | -3.7 | -3.8 |

Source. Data from domestic authorities; estimates (e) and predictions (p) are based on the authors' calculations.

## Monetary policy

Monetary policy continued to focus on maintaining price and exchange rate stability, while supporting judicious growth in credit to the private sector. In line with this objective, the NBE primary monetary policy target, base money, increased by 22.7% in 2016/17 compared to 16.3% in 2015/16. As a result, the share of private sector credit in GDP increased from 11.4% in 2014/15 to 13.5% in 2016/17 and headline inflation was below the NBE's 8% target in 2016/17 (Table 1). NBE reduced the 2017/18 base money target to 16.5% to address inflationary pressures that emerged during the second half of 2017 due to rising food prices. Annual headline inflation increased from 7.0% in February 2017 to 15.6% in February 2018, with food inflation leaping from 6.2% to 20.9%. In the short term, the Government will increase food imports to cushion the most vulnerable from the rising food prices while implementing long-term measures such as irrigation to increase agriculture productivity.

NBE follows a managed exchange rate system and implements an exchange rate policy to achieve a stable real exchange rate. However, a higher than planned inflation differential and global strengthening of the dollar, especially during 2014-15, contributed to the overvaluation of the Ethiopian Birr (ETB) in real terms by an estimated 20% during 2016/17. As a result, the Government of Ethiopia devalued ETB by 15% in October 2017 to improve competitiveness. NBE is currently implementing measures to reduce the impact of exchange rate movements on domestic prices by, for example, increasing the minimum deposit rate to promote savings and limiting credit expansion to non-export sectors.

## Economic co-operation, regional integration and trade

Ethiopia is a member of the Common Market for Eastern and Southern Africa (COMESA) and the Inter-Governmental Authority on Development (IGAD). The country has also ratified several regional integration protocols. Cross-border financial activities/investments are constrained, however, by the absence of enabling legislation, particularly related to the harmonization of fiscal regimes, banking and insurance, and the stock exchange. Ethiopia is among the 44 countries that signed the protocol establishing the African Continental Free Trade Area (AfCFTA) in March 2018. The AfCFTA pledges to eliminate tariffs on 90% of goods and to gradually eliminate the remaining 10%. In addition, negotiations to join the World Trade Organization (WTO) and the Economic Partnership Agreement (EPA) with the European Union are ongoing.

Merchandise exports increased by 1.4% to USD 2.9 billion in 2016/17 compared to last year. Coffee is the leading export, accounting for 30.4% of total exports earnings, followed by oilseeds (12.1%), pulses (9.6%), chat (9.4%), flowers (7.5%), and gold (7.2%). The leading six export items accounted for over 76.2% of total export earnings whereas largely unprocessed commodities account for over 90% of total merchandize export receipts, indicating the need to reduce export concentration. Ethiopia's imports from and exports to African countries accounted for 3.5% and 22.3% of total imports and exports, respectively, in 2016. The largest share of this trade is with countries in Eastern Africa.

**TABLE 4.** Current account (percentage of GDP)

| | 2009/10 | 2014/15 | 2015/16 | 2016/17 | 2017/18(e) | 2018/19(p) | 2019/20(p) |
|---|---|---|---|---|---|---|---|
| Trade balance | -19.8 | -20.8 | -19.1 | -16.0 | -16.2 | -16.6 | -16.8 |
| Export of goods (f.o.b) | 6.3 | 4.7 | 4.0 | 3.6 | 3.2 | 3.2 | 3.1 |
| Import of goods (f.o.b) | 26.2 | 25.5 | 23.1 | 19.6 | 19.4 | 19.8 | 20.0 |
| Services | -1.5 | -0.5 | -0.9 | -0.7 | 0.0 | 0.2 | 0.3 |
| Factor income | -0.2 | -0.4 | -0.4 | -0.6 | -0.6 | -0.6 | -0.6 |
| Current transfers | 19.0 | 10.9 | 10.3 | 8.3 | 8.3 | 8.3 | 8.4 |
| Current account balance | -2.6 | -11.5 | -9.2 | -8.1 | -8.5 | -8.8 | -8.7 |

Source. Data from domestic authorities; estimates (e) and predictions (p) are based on the authors' calculations.

Merchandise imports decreased by 5.5% to 15.8 billion in 2016/17 compared to the previous year, reducing the trade deficit to USD 12.8 billion in 2016/17, which is about USD 1 billion lower than the previous year. Consequently, the overall balance of payments position posted a surplus of USD 658.6 million in 2016/17 compared to a deficit of USD 830.9 million in 2015/16.

Ethiopia's cross-border trade and logistics indicators are still among the lowest in Africa. For instance, Ethiopia ranked 167 out of 190 countries in the World Bank's 2018 Doing Business report on trading across borders, with no improvement from the 2017 rating. Furthermore, it takes 51 and 166 hours to export and import goods, respectively, while the cost to export and import (border compliance) is also high at USD 172 and USD 738, respectively. Despite introducing the electronic Single Window (e-SW) system for customs in 2015, Ethiopia ranked 126 out of 160 countries on the 2016 Logistics Performance Index, with urgent improvements required in tracking and tracing, as well as international shipment logistics quality and competence.

### Debt policy

The Government has a debt strategy that guides the management of public debt. The debt management strategy incorporates several good practices, including the application of international systems in the recording and management of domestic and external debt. Other good practices include the registration of debt agreements and reconciliation of debt balances with creditors on a quarterly basis. To improve transparency, the Government publishes a quarterly bulletin detailing debt service, stock, and operations.

The 2018 IMF Article IV Debt Sustainability Analysis (DSA) reported that Ethiopia's risk of external debt distress increased from 'moderate' in 2016 to 'high' in 2017. This deterioration is due to poor export performance and increased debt service obligations for maturing non-concessional debt. Public and publicly guaranteed (PPG) debt increased from 56% of GDP in June 2016 to 56.9% of GDP in June 2017, with external debt remaining stable at 30.7% and 30.4% of GDP. The share of private creditors in PPG external debt reduced to 27.3% in 2016/17 from 30.1% in 2015/16. The debt liquidity indicators for PPG external debt were well within the sustainable threshold. However, one of the solvency indicators, the present value of debt to export ratio at 280.9 in 2016/17 was almost twice the sustainable threshold of 150.

Addressing Ethiopia's debt distress vulnerabilities requires reducing export concentration and diversification of the public financing sources. The development of industrial parks is expected to diversify exports, with the investments in energy infrastructure also projected to generate energy exports of up to USD 1 billion by 2020. The adoption of a public-private partnership (PPP) law, drafted with assistance from the African Development Bank, in January 2018 is expected to facilitate the mobilization of private investments in public infrastructure projects.

## ECONOMIC AND POLITICAL GOVERNANCE

### Private sector

Accelerating the transformation of domestic private investors/entrepreneurs is one of the pillars of GTP II, which reaffirms the Government's commitment to private sector development. Ethiopia's investment law has undergone frequent revisions to improve the investment climate and promote the role of the private sector. The Government upgraded the investment agency to a Commission and reinforced its institutional capacity to champion investment promotion efforts. The recently enacted PPP legislation seeks to establish a favourable framework for the implementation of privately financed infrastructure projects. These legislative and institutional improvements will increase the private sector's contribution to job creation and transformative growth, in line with the GTP II objectives.

As part of the G20 Compact with Africa, Ethiopia has articulated several key policy actions to improve the investment climate, with a specific focus on maintaining macroeconomic stability and strengthening the business framework. These actions will complement ongoing measures to streamline licensing requirements, eliminate any remaining barriers to entry and exit, and strengthen the legal framework for anti-competition behaviour. In addition, the bi-annual public-private dialogue provides a forum for the Government to interact with the private sector on key impediments to the sector's development. An investor satisfaction survey planned in 2018 will also inform the required investment climate reforms.

The above measures will contribute to improvements in Ethiopia's Doing Business ranking, which worsened to 161/190 in 2017 from 159/190 in 2016. Urgent action is required, especially in the categories 'starting a business', 'dealing with construction permits', 'protecting minority investors', and 'getting credit'. Ethiopia's ratings on the 2017-18 Global Competitiveness Report were also low (108/137 in 2017 and 109/138 in 2016). Key impediments to improved competitiveness include low access to finance, regressive foreign currency regulations, high tax rates, inefficient Government bureaucracy, and inadequate infrastructure supply and services.

### Financial sector

Ethiopia's formal financial sector consists of 17 commercial banks (one State-owned and 16 private), a State-owned development bank, 17 insurance companies and about 35 microfinance institutions. Banking dominates the financial sector in terms of value and services offered. The number of bank branches increased to 4 257 in June 2017, compared to 3 301 the previous year, reducing the bank branch-to-population ratio from 1:27 932 to 1:22 164. The distribution of bank branches is improving gradually, with Addis Ababa and private banks accounting for 32.9% and 66.6% of bank branches in 2016/17 compared to 34.4% and 60.5% the previous year. The total capital of the banking sector increased by 81% to ETB 78.0 billion (USD 2.8 billion) in June 2017 compared to the previous year, with private banks accounting for 35.6% of this capital increase. The Commercial Bank of Ethiopia accounted for 54.6% of the total capital of the banking sector.

The banking sector remains sound and profitable. The capital adequacy ratio of the commercial banking sector, at 21.5% in June 2017, was higher than the 15.5% recorded in June 2016. The return on assets and return on equity, which indicate the level of earnings and profitability, were also largely stable at 2.4% and 29.6%, respectively in June 2017. The non-performing loans (NPL) ratio, estimated at 2.6% in June 2017, was below the statutory 5% benchmark, confirming the strong asset quality of the commercial banking sector. NBE regularly monitors banks' adherence to Basel capital adequacy requirements and commercial banks' risk adjusted capital adequacy ratios are well above the 8% threshold.

Deposits increased by 29.8% in 2016/17, 10 percentage points higher than the previous year, due to the expansion of bank branches and higher per capita incomes. However, the financial sector remains shallow and offers a limited range of financial products and services. Capital markets are yet to be developed and lending is mainly collateral-based, thereby limiting access to credit. According to the 2017-18 Global Competitiveness Report, Ethiopia scored 3.4 out of 10 and ranked 109 out of 137 countries in terms of financial market development. The 2018 Doing Business ranking on getting credit was also low at 173 out of 190 countries.

### Public sector management, institutions and reforms

Basic services delivery and poverty reduction are a centrepiece of Government policies and strategies. Subsequently, budget allocations to sectors with a high potential for poverty reduction have averaged over 65% of total expenditure since 2010. The joint review and implementation support of basic service delivery programme confirms this strong progress, especially with respect to access to basic services. Government focuses on improving the quality of basic services.

Public financial management (PFM) has registered several improvements. Key successes were in legislative scrutiny of the annual budget law, quality, and timeliness of in-year budget reports, and the comprehensiveness of information included in budget documentation. Others include the roll-out of integrated budget expenditure, the establishment of an auditors and accountants board, operationalisation of the PFM, and procurement-certificate training programmes. Areas that need urgent improvement include financial transparency and accountability and use of performance-based budgeting. The Government implemented a major anti-corruption campaign, leading to the prosecution of several Government officers and businesspersons suspected of corruption. However, Ethiopia's rating on Transparency International's Corruption Perception Index, at 107 out of 180 counties in 2017, was unchanged compared to the previous year.

The regulatory system is strong and protects interests in property. Investment licenses are easy to obtain from the Ethiopian Investment Commission. The Government consults the public during the preparation of proposed national laws before their approval and ratification. Adequate dispute resolution mechanisms exist and property as well as contractual rights are recognized. Commercial and bankruptcy laws are also in place. However, the 2018 Index of Economic Freedom categorized Ethiopia as 'mostly unfree'; it was ranked 142 out of 180 countries.

### Natural resource management and the environment

Ethiopia's 2015 nationally determined contributions (NDC) set out the country's major commitments and priorities related to climate change adaptation and mitigation. The NDC proposes a 64% reduction in greenhouse gas (GHG) emissions by 2030 (relative to a 'business-as-usual' scenario). The targeted 255 MtCO2e GHG reduction underpins on mitigation and adaptation initiatives to reduce vulnerability to climate change in line with the Climate Resilient Green Economy Strategy (CRGE) and GTP II.

The CRGE strategy provides a comprehensive framework for a development strategy that minimizes the country's vulnerability to, among others, climate change shocks. In spite of these plans and policy frameworks, Ethiopia remains susceptible to climate change shocks such as droughts, and must therefore be ready to take further adaptation and mitigation actions. Legal, policy and institutional frameworks for addressing climate change, protecting the environment and using natural resources sustainably have been developed and are being implemented at federal, regional and district levels, including a ten-year forest sector development programme. The Government is mobilizing resources to finance adaptation interventions, such as solar powered water pumps for the drought prone regions. In addition, Ethiopia is using its leadership of the Climate Vulnerable Forum (CVF) to champion reductions in GHG emissions and build resilience to climate change shocks. The CVF is an international partnership of 43 countries that are highly vulnerable to global warming.

### Political context

Widespread anti-Government protests continued in 2017, with wide sections of the population citing lack of employment opportunities and concerns about governance, particularly democracy and corruption, as the major cause of these protests. The Government implemented several measures to ensure the return to peace and stability, including the lifting of a 10-month state of emergency in August 2017. Other reforms included the establishment of a USD 0.5 billion revolving fund to support entrepreneurship and job creation among youth; dialogue with opposition political parties; and the release of over 6 000 prisoners, including prominent political detainees. However, the protests did not subside and contributed to the resignation of former Prime Minister Hailemariam Desalegn in February 2018. As a precautionary measure, Ethiopia declared a six-month state of emergency in February 2018 to enable the Government to implement required governance reforms. The inauguration of H.E Dr. Abiy Ahmed Ali as Ethiopia's new Prime Minister in April 2018 is expected to accelerate the implementation of reforms to achieve peace and democracy.

Disagreements between neighbouring Oromia and Somali Regional States over their 1 000 km border increased in August 2017, leading to several casualties and displacing over 800 000 people. The Federal Government and the two affected regional states are working jointly to restore security and resolve the border disputes.

Ethiopia's location in a volatile region also affects its security and political stability. To counter these threats, the Government is working with other countries in the region, the African Union, the Inter-Governmental Authority on Development, and the United Nations to support peace and stability, particularly in Sudan, South Sudan, and Somalia. The March 2015 conciliatory agreement between Ethiopia, Egypt and Sudan outlining principles of co-operation on use of the River Nile waters has eased tensions with Egypt in relation to construction of the Grand Ethiopian Renaissance Dam.

## SOCIAL CONTEXT AND HUMAN DEVELOPMENT

### Building human resources

The 2017 Mo Ibrahim Index of African Governance (IIAG) shows improvements in human development both over the last ten years (+14.3 points) and the last five years (+3.4 ), due to progress in education (+10.5) and health (+24.8). However, the pace of progress appears to be slowing, since the average annual increase was +0.85 points in the last five years, but +1.59 in the last decade. The Human Development Index increased from 0.284 in 1990 to 0.448 in 2015, indicating an average annual increase of 3.21%. However, Ethiopia's human development ranking remained low, at 174 of 188 countries in 2014 and 2015.

Ethiopia has started to integrate the Sustainable Development Goals (SDGs) into GTP II. The 2015 MDG assessment reported that Ethiopia achieved six of the eight MDGs by the end of 2015. In health services, Ethiopia made progress in increasing the contraceptive prevalence rate, coverage of antenatal visits, and reduction in under-five and infant mortality. However, more needs to be done to reduce maternal mortality from the 2015/16 level of 412 deaths per 100 000 live births.

The primary school net enrolment rate increased from 68% in 2004/05 to 96.9% in 2015-2016 whereas the completion rate of grade eight students grew marginally from 48% in 2009-2010 to 52.2% in 2015-2016. Consequently, Ethiopia fell short of achieving universal primary education (MDG 2). Ongoing education sector interventions focus on improving education quality and expanding access to vocational training and tertiary education, to develop a workforce capable of supporting the country's structural transformation ambitions.

The HIV/AIDS prevalence rate fell from 4.5% in 2000 to about 1.2% in 2016, exceeding the MDG target of less than 4.5%. This progress is due to the Government's strong emphasis on scaling up coverage and universal access to HIV prevention, treatment, care and support.

The share of population with mosquito treated bed nets and indoor residual spray reached 97% in 2016 from 22% in 2010, and all residents of malaria-prone areas have an insecticide-treated mosquito net.

## Poverty reduction, social protection and labour

Ethiopia's high growth trajectory, averaging over 10% between 2003/04 and 2016/17, permitted significant gains in poverty reduction. Poverty dropped from 29.6% in 2011 to 23.4% in 2015/16, surpassing the MDG target of 24%. This reduction is attributed to the implementation of poverty reducing public expenditure policies, with over 65% of the budget allocated to poverty-related sectors. Implementation of welfare programmes also contributed, including the productive safety net programme (PSNP), food security programmes, and urban productive safety net projects.

Income inequality, as measured by the Gini coefficient, remained low at 0.32 in 2015/16, slightly higher than the 0.3 recorded in 2004/05. However, significant disparities in poverty and income inequality exist within regions and in *woredas* (districts).

The Government established the PSNP in 2005 to provide predictable safety net support to Ethiopians who are chronically food insecure. Subsequently, the Government approved a national social protection policy in 2014 to provide a holistic framework for social protection. The policy and strategic framework focus on productive safety nets, livelihoods and employment support, social insurance, and access to social services. PSNP provided food and other support to over 7.5 million people affected by persistent droughts during 2015-17.

The labour laws and labour market regulations are generally adequate and are enforced. Major labour market challenges are low pay and subsequent high staff turnover. As a result, several labour market programs are being implemented to expand coverage and the quality of employment. These include interventions to link micro and small-scale enterprises with public works, notably paving urban roads, and housing projects. The recent labour force survey conducted in 2013 estimated urban unemployment at 16.5%.

Ethiopia has ratified several ILO conventions, including ILO Convention 182 on the Worst Forms of Child Labour. However, enforcement of these conventions, especially the child labour convention, needs to be strengthened.

## Gender equality

According to the 2017 Mo Ibrahim Index of African Governance, Ethiopia's record on gender outcomes has improved. Based on an index of eight indicators, Ethiopia scored higher both in the last ten years (by about +19.7 points) and in the last five years (by +10.6 points). Progress is due to improvements in women's political participation (annual average trend of +2.26 points), education (+1.53 points), and increases in women representation in the judiciary (+8.33 points). The Government considers gender equality and mainstreaming to be a core component of national development, and gender equality and empowerment of women are a pillar of GTP II. The Federal Ministry of Women and Children Affairs works jointly with its counterparts in regional states to mainstream gender in their jurisdictions.

The gender parity index in primary school enrolment reached 0.90 in 2017 from 0.70 in 2000. The share of married women using modern contraceptives grew from 13.7% in 2005 to 36% in 2016, largely due to increased access to contraceptives. Access to health care for women has also improved. For instance, 28% of Ethiopian women gave birth under the care of a skilled health professional in 2016 compared to only 10% in 2011. The share of seats in the national Parliament held by women rose to 38.7% in 2015, compared to 27.8% in 2010. However, the participation rate of women in business and decision-making needs to be improved. Women are concentrated in lower level jobs. Women hold just 27% of managerial positions and 32% of professional posts, but 64% of clerical jobs and 65% of service related jobs. In addition, the adult literacy rate of women (42% is lower than that of men (62%).

## THEMATIC ANALYSIS: INFRASTRUCTURE FINANCING

### Overview of current infrastructure

The Growth and Transformation Plans I and II (GTP I and GTP II) both identified infrastructure as a key driver of structural transformation, and prioritized public infrastructure spending. However, Ethiopia's score on the GCI infrastructure pillar has remained stable (on a scale of 1 to 7, where 7 is best) at 2.7 in 2010/11, 2.8 in 2016/17 and 2.7 in 2017/18, below the 2017 Sub-Saharan African (SSA) average score of 2.9.

In the energy sector, several key energy projects were completed including Gilgel-Gibe II (420 MW), and III (1 870 MW) hydro power plants, increasing generation capacity from 2 177 MW in 2011/12 to 4 269.5 MW at the end of 2017. As a result, electricity access increased from 48.5% to 60%. Additional investments are under implementation, notably the Grand Ethiopian Renaissance Dam (GERD, 6 450 MW) and Genale Dawa III (254 MW) hydropower and wind, solar, and geothermal projects. These renewable energy projects are expected to increase generation capacity to over 10 000 MW by 2020 and potentially generate over USD 1 billion in energy exports. However, the GCI scored Ethiopia relatively low on the quality of its electricity supply in 2017. Its rating of 3.2 (on a reliability score of 1 to 7, where 7 was most reliable) was comparable to the Sub-Saharan Africa average of 3.1 but below the East African Community average of 3.5.

In the transport sector, road density has increased from 44.4km/1 000km$^2$ in 2010/11 to 109.2km/1 000km$^2$ in 2016/17, although this is still short of the 200km/1 000km$^2$ 2019/20 GTP II target. Flagship investments include the Bank supported 1 200 km Mombasa-Nairobi-Addis Ababa transport corridor project, which will contribute to a five-fold increase in trade between Ethiopia and Kenya when completed in 2020. In addition, the 646 km Addis-Djibouti railway commenced commercial service in January 2018 and this will reduce travel time between Addis and the Port of Djibouti from 3-4 days to about 10 hours. Investments in air transport services have increased Ethiopia's airline seat kilometres (in millions) per week to 442.5 in 2017/18, which ranks the country second in Sub-Saharan Africa behind South Africa (1 273.6). However, Ethiopia's 2017/18 GCI score for airport infrastructure at 4.2 (1 to 7 where 7 is best) lagged behind Kenya (4.9) and Rwanda (4.7), although it was higher than the Sub-Saharan Africa average (3.6).

The telecom sector is still underdeveloped. Ethiopia's GCI ranking on mobile-cellular telephone subscriptions increased only slightly from 139 out of139 countries in 2010/11 to 133 out of 137 countries in 2017/18. In addition, Ethiopia rated 170 out of 176 countries on the 2017 International Telecommunications Union's ICT Development Index. ICT investments aim to address these impediments, and include the 2015 launch of the fourth generation (4G) long-term evolution (LTE) service, which consolidates previous investments such as the 4 000km fibre backbone network laid in 2005. The number of mobile subscribers is expected to increase from 38.8 million in 2014/15 to 103.6 million in 2020 and the number of internet subscribers from 9.4 million to 56 million. Investments in water and sanitation have improved national access to potable water from 52.1% in 2011 to 65.7% at the end of 2017, although this is still below the GTP II 2019/20 target of 83%. National access to sanitation facilities fell from 67% in 2011 to 61% at the end of 2017, also short of the 82% 2019/20 target.

### Finance landscape

The GTP I and II structural transformation objectives have been anchored on public infrastructure spending, and a large share of this investment has been undertaken by State-Owned Enterprises (SOEs), notably Ethiopian Electric Power (EEP), Ethiopian Electric Utility (EEU), Ethiopian Telecom (ET), and Ethiopian Railway Company (ERC). The share of capital spending in total expenditure has averaged 54.7%, or 9.6% of GDP per year (USD 4.98 billion), between 2010/11 and 2016/17. This capital spending has been financed from the central treasury or from domestic resources, including tax revenues, borrowing from the domestic financial sector, advances from the central bank, and sale of treasury bills; external grants; and loans. Domestic resources financed an average of 76% of capital spending (USD 3.79 billion) annually during the same period; the remainder (USD 1.18 billion) was financed by external grants and loans.

Non-market forms of infrastructure financing have been prioritized, particularly external loans from multilateral partners, official bilateral creditors, and commercial loans from non-traditional creditors such as China. Domestic non-tax financing for infrastructure has primarily been mobilized from State-owned banks, namely the Commercial Bank of Ethiopia (CBE) and the Development Bank of Ethiopia (DBE). Government securities have also been issued to finance infrastructure, for instance in the case of the GERD, but their terms have also been below market rates.

Ethiopia's reliance on non-market infrastructure financing is consistent with the country's development approach, which emphasizes the role of SOEs as key catalysts for structural transformation, and is in part due to limited financial sector development. In spite of the Government's cautious approach, the country's growing infrastructure financing needs have led to the acquisition of external commercial credit. For instance, the energy and telecom utilities acquired commercial loans and suppliers' credits backed by Government guarantees between 2011/12 and 2016/17, primarily from China and Turkey. In addition, a USD 1 billion Eurobond was issued in December 2014 for industrial parks and expansion of sugar production.

Consequently, Ethiopia's public and publicly guaranteed (PPG) external debt has increased steadily from 18.5% of GDP in 2011/12 to 30.4% of GDP (USD 22.2 billion) in 2016/17. For instance, up to USD 2.8 billion in new public sector external loans was acquired in 2016/17. 50% of these commitments were provided by multilateral partners in the form of concessional loans. The remaining 50% comprised loans largely acquired from the EXIM Bank of China at below market terms and with an estimated 30% grant element. The loans acquired in 2016/17 were invested in power and water infrastructure. Commercial loans accounted for a small share of total external loan commitments in 2016/17, amounting to less than USD 100 million, and were invested in power generation and transmission projects.

Domestic financing is another key source of infrastructure financing and has contributed to a rise in domestic debt from 15.8% of GDP in 2011/12 to 26.5% of GDP in 2016/17. Domestic debt of the central Government (23% of total debt in 2016/17) is owed to banks (largely the central bank, for advances to finance budget and treasury bills), whereas most of the domestic debts of SOEs (22.6% of total debt) are loans or bond issues held by domestic banks. However, using the domestic financial sector to finance public infrastructure investments crowds out the private sector and intensifies external sector pressures by increasing the demand for capital imports. In addition, borrowing by SOEs, with or without Government guarantees, has the potential to create contingent liabilities with implications for macroeconomic stability.

Therefore, diversification of the public finance sources, designed particularly to crowd in additional private sector investment and finance, is critical. In this regard, a PPP law, prepared with the African Development Bank's support, was ratified in January 2018. In addition, the Government has concluded an independent power production agreement with a private developer for Tulu Moye and Corbetti geothermal projects, each having a capacity of 520 MW and an estimated implementation cost of USD 2.2 billion.

GTP II estimates that Ethiopia's infrastructure-related financing needs will amount to ETB 3.23 trillion (USD 118.89 billion at the March 2018 exchange rates) between 2015/16 and 2019/20. This includes on-budget capital spending of ETB 1.31 trillion (USD 48.24 billion) and off-budget investment of ETB 1.92 trillion (USD 70.64 billion). On-budget capital expenditure on infrastructure (energy, transport, potable water, and irrigation) is estimated at USD 23.35 billion, representing 48.4% of total on-budget capital spending. GTP II projects that 86% of Government on-budget capital spending (USD 20.08 billion) will be financed through domestic revenue and grants, yielding a funding gap of 14% (USD 3.26 billion) to be financed through external loans (38.8%) and domestic borrowing (61.2%). The off-budget financing is expected to be mobilized from the banking sector and bond sales, 62% of which is expected to be allocated to the private sector and the remainder to SOEs investments.

### Challenges

Sustainability of infrastructure financing and capacity limitations are among the key challenges. As discussed earlier, external loans and domestic financing are a major, albeit unsustainable source of infrastructure financing. For instance, Ethiopia's PPG debt to GDP ratio has increased from 37.4% in 2010/11 to 56.9% of GDP in 2016/17 and the country's external risk of debt distress increased from moderate to high in 2018. Therefore, ongoing measures to reduce external borrowing and stabilise public debt are expected to decrease infrastructure financing. While increased public investment is necessary to stimulate private investment, extensive use of domestic credit to finance public infrastructure could potentially reduce the private sector's access to credit, and thereby constrain private investment. The recently approved PPP law is expected to diversify the infrastructure financing sources. Regarding capacity constraints, while the regulatory and institutional framework for infrastructure development has been strengthened, local contractors continue to be plagued by capacity limitations. In addition, capacity weaknesses at the regional state level has slowed down the implementation of decentralized public infrastructure, such as water and sanitation.

### Innovative solutions and policy recommendations

Addressing the country's infrastructure bottlenecks as articulated in GTP II will require a strategic approach to infrastructure development and financing, with a focus on prioritization, sustainability, and empowerment of local contractors. First, infrastructure investments should prioritize industrial zones and corridors that link remote but productive regions with centres of trade such as urban and border regions to maximize benefits for rural households and returns on investments. In addition, emphasis should be placed on infrastructure projects with the highest returns in terms of poverty reduction, export growth, and private sector development. Second, the sources of public infrastructure financing should be diversified through increased domestic savings and public revenue mobilization, use of PPPs in line with the recently approved PPP legislation, securitization of infrastructure assets especially for the profitable SOEs, and privatization. To safeguard macroeconomic stability, the fiscal risks associated with private investments in public infrastructure projects should be adequately managed. In this regard, the Bank has supported capacity development for the authorities in domestic debt/ capital markets development and public debt management. Third, cost reflective tariffs for infrastructure services, notably electricity, should be adopted to offset part of the energy investment costs. For instance, Ethiopia's tariff at USD 0.03/kWh is lower than the average tariffs in Tanzania (USD 0.10/kWh), Uganda (USD 0.13/kWh) and Kenya (USD 0.18/kWh). Fourth, in addition to providing capacity development for local contractors, legislation should emphasize local content. For instance, the procurement legislation could earmark selected activities for local contractors and also require international contractors to transfer knowledge to their local counterparts.