Country Report

Ethiopia

Ethiopia at a glance: 2007-08

OVERVIEW

The Economist Intelligence Unit expects the ruling Ethiopian People's Revolutionary Democratic Front (EPRDF) to remain firmly in power over the forecast period. However, as a result of the ongoing trial of opposition leaders accused of treason for fomenting protests following the elections in May 2005, we expect a sustained period of political uncertainty. Tensions along the Ethiopia-Eritrea border are also expected to continue, and tensions along the Somali border look set to intensify as Ethiopia's growing involvement in Somalia attracts opposition from Somalis in Ethiopia's Ogaden region. Real GDP growth in fiscal year 2006/07 (ending July 7th) is estimated at 7%, but is forecast to slow to 5.8% in 2007/08 as the margins for gains in agriculture become smaller following four years of large harvests. The rate of inflation is expected to fall to 8% in 2007 as both food and oil prices begin to come down, and to 7.5% in 2008 as oil prices fall further. The current-account deficit is expected to remain large, owing mainly to high imports growth and a move into deficit on the services account. As a result, the current-account deficit is forecast to remain substantial, at around 16.5% of GDP in 2007 and 2008.

Key changes from last month

Political outlook

- There have been no significant changes to our political outlook in the last month.

Economic policy outlook

- There have been no changes to the economic policy outlook in the last month.

Economic forecast

- There have been no changes to the economic forecast in the last month.

January 2007

The Economist Intelligence Unit
26 Red Lion Square
London WC1R 4HQ
United Kingdom

The Economist Intelligence Unit

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London
The Economist Intelligence Unit
26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

New York
The Economist Intelligence Unit
The Economist Building
111 West 57th Street
New York
NY 10019, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: newyork@eiu.com

Hong Kong
The Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

Website: **www.eiu.com**

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Ethiopia

January 2007

Summary

Outlook for 2007-08

The Economist Intelligence Unit expects the ruling Ethiopian People's Revolutionary Democratic Front (EPRDF) to remain firmly in power over the forecast period. However, as a result of the ongoing trial of opposition leaders accused of treason for fomenting protests following the elections in May 2005, we expect a sustained period of political uncertainty. Tensions along the Ethiopia-Eritrea border are expected to continue, and tensions along the Somali border look set to intensify as Ethiopia's growing involvement in Somalia attracts opposition from Somalis in Ethiopia's Ogaden region. Real GDP growth in fiscal year 2006/07 (ending July 7th) is estimated at 7%, but will slow to 5.8% in 2007/08 as the margins for gains in agriculture become smaller following four years of large harvests.

The political scene

The final official report of the commission of inquiry into post-election violence in June and November 2005 found that 199 people were killed during the protests. A leading member of the commission has sought asylum in the UK. Two EU officials were expelled in October 2006 for allegedly trying to smuggle a local EU employee out of the country. The trial of opposition leaders has continued to move slowly. The border dispute between Ethiopia and Eritrea has remained in stalemate. The risk of conflict between Ethiopian troops and Islamists in Somalia has been increasing.

Economic policy

The prime minister, Meles Zenawi, sacked the long-standing federal auditor-general, Lema Argaw, in November 2006, without following proper constitutional procedures. This has raised concerns about transparency and good governance. The World Bank conducted its first review of its protection of basic services programme in October 2006. Multilateral and bilateral donors have continued to pledge substantial funding despite the strained political situation.

The domestic economy

Early indicators have shown another bumper crop is likely in the 2006/07 *meher* season. High food and petrol prices have continued to drive up inflation. Ethiopia and Starbucks have failed to resolve a dispute over trademarking of Ethiopian coffee names. Private banks posted record profits in the 2005/06 financial year. Ethiopian Airlines profits were down in 2005/06. New entrants into the air freight sector have increased competition in the sector.

Foreign trade and payments

A sharp rise in imports widened the trade and current-account deficits substantially in 2005. Foreign direct investment was much lower in 2005 than in 2004. Ethiopia has taken further steps towards joining the World Trade Organisation.

Editors: Christopher Eads (editor); Philip Walker (consulting editor)
Editorial closing date: December 18th 2006
All queries: Tel: (44.20) 7576 8000 E-mail: london@eiu.com
Next report: Full schedule on www.eiu.com/schedule

Political structure

Official name	Federal Democratic Republic of Ethiopia
Form of state	Federal republic
Legal system	The federal constitution was promulgated by the transitional authorities in December 1994; in May 1995 representatives were elected to the institutions of the new republic, which formally came into being in August 1995
National legislature	The Federal Assembly consists of the Council of People's Representatives (lower house; 547 members) and the Council of the Federation (upper house; 108 members); the nine regional state councils have limited powers, including that of appointing members of the Council of the Federation
National elections	May 2005 (federal and regional); next elections due in May 2010
Head of state	President—a largely ceremonial role, appointed by the Council of Peoples' Representatives; currently Girma Wolde-Giorgis (appointed October 2001)
National government	The prime minister and his cabinet (Council of Ministers), appointed in October 2005
Main political parties	The Ethiopian People's Revolutionary Democratic Front (EPRDF) evolved from the coalition of armed groups that seized power in May 1991; it includes the Tigray People's Liberation Front, the Amhara National Democratic Movement, the Southern Ethiopia People's Democratic Movement and the Oromo People's Democratic Organisation; the party won again in the May 2005 election, but with a reduced majority Opposition parties include: Coalition for Unity and Democracy Party (CUDP); United Ethiopian Democratic Front (UEDF)

	Prime minister	Meles Zenawi
	Deputy prime minister & minister of agriculture	Addisu Legesse
Key ministers	**Capacity building co-ordination**	Tefera Waliwa
	Defence	Kuma Demekesa
	Education	Sentayehu Woldemichael
	Federal affairs	Siraj Fegisa
	Finance & economic development	Sufian Ahmed
	Foreign affairs	Seyoum Mesfin
	Health	Tewodros Adhanom
	Information	Berhanu Hailu
	Justice	Asefa Kesito
	Labour & social affairs	Hassan Abdella
	Mines & energy	Alemayehu Tegenu
	Revenue & income	Melaku Fenta
	Trade & industry	Girma Birru
	Transport & communication	David Ruach Tang
	Water resources	Asfaw Dingamo
	Works & urban development	Kassu Illala
	Youth & sports	Aster Mamo
Central bank governor	Teklewold Atnafu	

Economic structure

Annual indicators

	2002[a]	2003[a]	2004[a]	2005[b]	2006[b]
GDP at market prices (Birr bn)	51.5	55.7	69.0	84.5	103.0
GDP (US$ m)	6,010.1	6,477.2	7,989.8	9,748.8	11,857.5
Real GDP growth (%)	2.0	-3.9	13.1	8.9	8.5
Consumer price inflation (av; %)	1.6	17.8	3.3	11.6[a]	12.2
Population (m)	72.0	73.8	75.6	77.4	79.4
Exports of goods fob (US$ m)	480.2	496.4	678.3	917.3[a]	1,114.6
Imports of goods fob (US$ m)	1,455.1	1,895.0	2,768.5	3,700.8[a]	4,274.3
Current-account balance (US$ m)	-136.6	-136.4	-667.8	-1,567.8[a]	-1,930.5
Foreign-exchange reserves excl gold (US$ m)	881.7	955.6	1,496.8	1,121.5[a]	1,289.1
Total external debt (US$ m)	6,526.1	7,187.2	6,574.0	5,679.5	2,795.0
Debt-service ratio, paid (%)	8.1	7.4	5.5	5.6	3.9
Exchange rate (av) Birr:US$	8.6	8.6	8.6	8.7[a]	8.7

[a] Actual. [b] Economist Intelligence Unit estimates.

Origins of gross domestic product 2004/05[a]	% of total
Agriculture & allied activities	48.2
Industry	13.2
Services	39.2

Components of gross domestic product 2004/05[a]	% of total
Private consumption	82.1
Government consumption	14.2
Gross domestic fixed investment	26.2
Exports of goods & services	16.3
Imports of goods & services	–39.0

Principal exports fob 2004/05[b]	US$ m
Coffee	335
Oilseeds	102
Khat	100
Pulses	36

Principal imports cif 2004/05[b]	US$ m
Capital goods	1,199
Fuel products	669
Semi-finished goods	665
Food	247

Main destinations of exports 2005[c]	% of total
Djibouti	13.8
Germany	12.1
China	8.8
Japan	7.7

Main origins of imports 2005[c]	% of total
Saudi Arabia	26.6
US	13.7
China	7.6
Italy	4.9

[a] Fiscal years ending July 7th; National Bank of Ethiopia figures. [b] International Trade Centre UNCTAD/WTO estimates. [c] Based on partners' trade returns; subject to a wide margin of error.

Quarterly indicators

	2004		2005				2006	
	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr
Prices								
Consumer prices, Addis Ababa (2000=100)	115.7	117.0	118.7	124.9	131.5	131.3	132.6	139.4
Consumer prices, Addis Ababa (% change, year on year)	1.1	5.8	10.2	10.3	13.7	12.2	11.7	11.6
Financial indicators								
Exchange rate Birr:US$ (av)	8.64	8.65	8.66	8.66	8.67	8.68	8.68	n/a
Exchange rate Birr:US$ (end-period)	8.64	8.65	8.66	8.67	8.67	8.68	8.69	8.69
Deposit rate (av; %)	3.37	3.37	3.42	3.47	3.48	3.48	3.51	3.55
Lending rate (av; %)	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Treasury bill rate (av; %)	0.69	0.11	0.16	0.05	0.69	0.1	0.04	0.04
M1 (end-period; Birr m)	21,384	22,312	24,101	25,609	25,894	25,981	28,022	n/a
M1 (% change, year on year)	24.1	20.0	18.8	20.0	21.1	16.4	16.3	n/a
M2 (end-period; Birr m)	38,006	39,605	41,835	44,541	46,382	46,968	49,521	n/a
M1 (% change, year on year)	20.7	19.3	18.4	20.5	22.0	18.6	18.4	n/a
Sectoral trends (annual totals; '000 tonnes)								
Coffee production[a]	(260	)	(	260		)	n/a	n/a
Foreign trade (Birr m)								
Exports fob	1,463.4	1,301.4	1,977.2	2,334.2	1,586.3	1,821.7	2,414.4	2,830.8
Imports cif	-7,458.4	-6,875.8	-7,746.4	-9,353.6	-9,259.9	-9,410.3	-9,421.1	-9,952.6
Trade balance	-5,995.0	-5,574.4	-5,769.2	-7,019.4	-7,673.6	-7,588.6	-7,006.7	-7,121.8
Balance of payments (US$ m)								
Merchandise trade balance fob-fob	-604.6	-562.7	-563.3	-686.7	-771.0	-762.5	-694.7	n/a
Services balance	-16.6	30.5	-31.5	-30.0	-96.9	-23.3	-66.4	n/a
Income balance	-1.4	-9.7	0.5	1.5	-3.7	-2.8	3.7	n/a
Net transfer payments	253.7	504.0	288.7	514.3	281.4	317.8	234.5	n/a
Current-account balance	-368.9	-37.8	-305.7	-201.0	-590.3	-470.8	-522.8	n/a
Reserves excl gold (end-period)	1,196.4	1,496.8	1,348.5	1,474.1	1,316.1	1,121.5	1,109.1	1,096.9

[a] Estimate for 2005.

Sources: Food and Agriculture Organisation; IMF, *International Financial Statistics*.

Outlook for 2007-08

Political outlook

Domestic politics

The Ethiopian People's Revolutionary Democratic Front (EPRDF) is expected to remain in power over the forecast period. However, the ongoing trial of more than 100 people, including the leadership of the Coalition for Unity and Democracy (CUD), as well as journalists, academics and members of civil society organisations, will continue to stoke political tension and fuel uncertainty. The defendants are accused of a range of offences, including treason, genocide and fomenting a coup. The prime minister, Meles Zenawi, and the EPRDF have refused all requests for the prisoners' release—even on bail—and insist that the legal process must take its course. Although not in favour of it, the international community has largely accepted the trial as part of the political reality in Ethiopia. The hope was that it would not take a long time (the government has promised a speedy trial), but delays have been commonplace and the Economist Intelligence Unit now expects that sentencing will not take place until mid-2007. At present, the expectation is that most of the prisoners will be found guilty and sentenced to serve time in jail. Under this scenario, the best case in terms of maintaining political stability would be if most were quietly released after serving a few years of their sentence, once their political powers had been drained. The most pressing concern is that there are a number of elderly defendants with pre-existing medical conditions and there is a risk that some will not survive internment, which could spark a new bout of political unrest.

Despite this, the political climate has calmed down considerably during 2006, and the government has managed to negotiate a working agreement with the bulk of the parliamentary opposition. The EPRDF signed deals in June 2006 with the two main opposition blocs covering parliamentary procedure and rules of conduct, and these represent an important step towards reconciliation. Prior to the deal, in April, the rump CUD formed a new political entity, the Coalition of Unity and Democracy Party (CUDP), which has been registered and accepted by the electoral authorities. The rump CUD (that is, the CUDP) now appears to have completely broken with the imprisoned CUD leaders. Parliament reconvened early in October after a three-month recess.

The activities of opposition forces outside parliament will remain equally important during the forecast period. In a key development, the more radical elements of the original CUD, which have refused to join parliament (in line with the imprisoned leaders' wishes), formed a new opposition grouping in May. This grouping, named the Alliance for Freedom and Democracy (AFD), was formed with outlawed opposition formations—such as the Oromo Liberation Front and the Ogaden National Liberation Front—that have waged a low-level war against the government for over a decade. The AFD is likely to be a cause of some disruption, as some elements will attempt to scale up the armed conflict, although their capacity to do so will remain limited.

International relations

Relations with Eritrea will continue to be high on the foreign policy agenda throughout the forecast period. The long-standing border dispute between the two countries remains at an impasse, and all attempts at a diplomatic solution have so far failed. The independent Eritrea-Ethiopia Boundary Commission (EEBC) has now given both parties until November 2007 to start demarcating the border that was defined by the commission in 2002, or else the changes will be incorporated into official maps, regardless of the physical demarcation. However, both sides have rejected the ultimatum. Ethiopia is reluctant to hand over the territory, and, despite accepting the EEBC ruling "in principle", seeks fresh talks prior to demarcation in order to make final adjustments to the border. Eritrea will maintain its policy of non-negotiation, believing that the border defined by the EEBC—which awarded the sensitive border town of Badme to Eritrea—should be implemented unconditionally. In the absence of any progress in the border dispute, the troop numbers of the UN Mission in Ethiopia and Eritrea (UNMEE) could be further reduced, or the mission's mandate could be downgraded to simple observer status. The situation remains tense, but war does not appear to be imminent.

Ethiopia strongly supports the interim Somali government—the internationally recognised legal authority, based in Baidoa (150 miles from Somalia's capital, Mogadishu) and led by a long-time ally of Ethiopia, Abdullahi Yusuf—and this support is expected to increase in the early part of 2007. The interim Somali government is pitted against the Union of Islamic Courts (UIC), which by late 2006 controlled much of southern Somalia, leaving the transitional government virtually surrounded in Baidoa. Ethiopia views the Islamist grouping with great concern, believing it to be linked to al-Qaida, and has vowed to protect the interim government. Towards the end of 2006 Ethiopian troops moved rapidly to the border, and reportedly into Baidoa itself, prompting the UIC to declare "holy war" on Ethiopian troops in its territory. Direct clashes have so far been limited to the occasional skirmish, partly because heavy rains have made many areas impassable, but fighting is likely to intensify once the floods have subsided towards the end of 2006 and in early 2007.

The UN, the African Union (AU) and the Intergovernmental Authority on Development (IGAD) will continue to struggle to find a diplomatic solution. These attempts may prove unsuccessful, however, as the UIC has totally rejected a key theme of the mediation effort, which is the dispatch of African peacekeeping forces. Adding further fuel to the fire, the UIC is receiving strong backing from Eritrea in the form of arms shipments, which raises the risk of conflict in Somalia sparking a regional conflagration.

Economic policy outlook

Policy trends

Despite the government's lack of an IMF programme, it will generally stick to an IMF-style policy framework in order to win donor backing for its plan for accelerated and sustained development to end poverty (PASDEP), which runs from 2006/07 to 2010/11 and replaces the sustainable development and poverty reduction programme (SDPRP). The PASDEP, like its predecessor, is based on Ethiopia's strategy of agriculture-led industrialisation, but plans for massive investment of Birr342bn (US$39.3bn), especially on infrastructure, are unlikely to be realised in full. It is possible but unlikely that Ethiopia will negotiate a new IMF programme, as funding from key bilateral and multinational donors (including the World Bank) remains secure, while Ethiopia and the IMF do not agree on some issues, such as allowing the entry of foreign banks.

Key donors may have opted not to cut off funds, but they have suspended direct support for the federal government budget and will instead transfer resources to the *woreda* (district) level, accompanied by strict quarterly monitoring. The main vehicle for this is the World Bank-led protection of basic services (PBS) project, within the context of an interim country assistance strategy, which could be worth up to US$1bn over two years. The World Bank has expressed its willingness to scale up funding under a full, three-year, country assistance strategy, from 2008/09, as long as the political situation remains stable. However, the Bank warns that if the situation were to deteriorate funding would be progressively withdrawn. Donors remain committed to a wide array of project funding in areas such as road building, energy, information and communications technology, public-sector capacity building and private-sector development. Implementation of these projects will help to create a more favourable environment for private business, although the private sector will continue to face a challenging operating environment and unfair competition from companies linked to the ruling party. In addition, a culture of state ownership and management still dominates government thinking, which has yet to embrace fully free-market reforms in many areas of the economy.

Fiscal policy

The IMF estimates that Ethiopia ran a budget deficit of 5.2% of GDP (10.7% of GDP excluding external grants) in fiscal year 2005/06 (ending July 7th). Revenue failed to hit initial targets because of a grant shortfall and inefficiencies in tax collection, and so did spending, as the government sought to cut the overall deficit. The new budget for 2006/07, unveiled in June, targets a 16% rise in spending, to Birr35.4bn. Once again, higher spending has been allocated to the priority sectors of health, education, agriculture and infrastructure. As a result, capital spending is forecast to take the lion's share of the budget with Birr16bn, followed by regional governments with Birr9.9bn (some of which will be directed to capital projects) and the federal government with Birr9.5bn. The new budget also reflects the redirection of World Bank funding to the *woreda* level via the PBS programme. The budget projects domestic revenue (from tax and non-tax sources) of Birr23.3bn—an increase of 43% from the 2005/06 level of Birr16.3bn, which seems overoptimistic—leaving a shortfall of Birr12.1bn. How much of the gap is filled by donor grants will determine the final level of the budget deficit. We project that the budget deficit will widen slightly, to 5.7% of GDP in 2006/07, largely because growth of domestic revenue will be lower than officially projected. The shortfall in 2006/07 will, as usual, be financed through a mix of domestic and external borrowing.

We project that the budget deficit will rise further, to 6% of GDP, in 2007/08 as the government pushes forward with its large-scale capital projects to improve infrastructure. In addition, the government will remain committed to high levels of anti-poverty spending and will remain dependent on donor support to achieve this. However, we do not anticipate any major scaling-up of aid in 2007/08, as the political situation is likely to remain tense, although we do expect support to increase slowly as relations with Western donors continue to improve over the forecast period.

Monetary policy

Monetary policy during the forecast period will remain geared towards ensuring prudent growth in money supply (including maintaining ceilings on domestic government borrowing of around 1% of GDP). However, the government's growing fiscal deficit is likely to make this target unreachable. In addition, the goal of keeping "core non-food" inflation to no more than 3% per year will be frustrated by the dominance of food prices in the consumer price index as well as the lack of co-ordination between fiscal and monetary policies: the large fiscal deficit will put pressure on the National Bank of Ethiopia (NBE, the central bank) to increase credit to the government. Furthermore, foreign-exchange reserves will remain under pressure because of strong import demand (driven by high oil prices and rapid economic growth) and may dip below the IMF's recommended level of three months of import cover. However, provided that donor support remains solid, the government should be able to contain domestic borrowing at a level that does not threaten monetary stability—assuming satisfactory food crop harvests.

Economic forecast

International assumptions

International assumptions summary
(% unless otherwise indicated)

	2005	2006	2007	2008
Real GDP growth				
World	5.0	5.4	4.7	4.8
OECD	2.5	2.9	2.1	2.4
EU25	1.7	2.7	2.2	2.2
Exchange rates				
¥:US$	110.1	116.2	105.0	97.5
US$:€	1.245	1.255	1.360	1.353
SDR:US$	0.677	0.679	0.645	0.641
Financial indicators				
€ 3-month interbank rate	2.19	3.08	3.86	3.90
US$ 3-month commercial paper rate	3.38	5.05	4.92	4.85
Commodity prices				
Oil (Brent; US$/b)	54.7	65.3	64.6	63.3
Gold (US$/troy oz)	445.0	604.3	673.8	650.0
Food, feedstuffs & beverages (% change in US$ terms)	-0.5	13.3	-0.2	1.5
Industrial raw materials (% change in US$ terms)	10.2	50.1	3.3	-16.4

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

The global economy will continue to expand at a brisk pace, although we project that world GDP growth (on a purchasing power parity basis) will dip from 5.4% in 2006 to average 4.8% in 2007-08. Growth in the key EU market will subside from 2.7% in 2006 to average 2.2% in 2007-08, although strong growth in China will boost Ethiopia's commodity exports. We believe that oil prices have peaked, and anticipate that they will ease gently, to US$64.6/barrel in 2007 and

US$63.3/b in 2008, to Ethiopia's advantage as an importer. International coffee prices (arabica) are expected to edge downwards to 104.3 US cents/lb in 2007 and 95.5 US cents/lb in 2008 as global surpluses increase.

Economic growth

The government estimates that real GDP grew by 8.5% in 2005/06—a third consecutive year of rapid expansion, mainly reflecting another bumper harvest due to favourable rainfall. Strong growth in the dominant agricultural sector, of about 10.5%, also helped to underpin solid expansion in industry and services. In 2006/07 the main *meher* harvest (October-December), which accounts for 90% of annual production, is expected to be of super-bumper proportions, following exceptionally heavy rainfall in most parts of the country. This was accompanied by severe flooding in lowland areas, causing significant socioeconomic losses. The rains were, however, good for highland crops and have filled hydroelectric dams to the brim. Real GDP growth will also be supported by rising investor confidence as political tensions ease (albeit gradually). Although the smaller margin for growth in agriculture after four good harvests will slow growth slightly, continuing policy reforms and investment in infrastructure will boost activity, and we project that the economy will grow by 7% in 2006/07.

We forecast that real GDP growth will slow in 2007/08, to 5.8%, as the margin for growth in agriculture after a number of consecutive healthy harvests will be shrinking. However, the robust state of the farming sector, also assisted by rising institutional support and the ongoing extension of roads and markets, will allow the sector to remain a significant source of GDP growth (assuming normal weather conditions). The projected slowdown in agriculture will dampen activity in other sectors, although this will be offset to some extent by improvements in policy and infrastructure, which will make it easier and cheaper to conduct business. Downside risks to growth include a severe drought and a deterioration in the political situation, which would also undermine vital donor support.

Inflation

The latest inflation data show that the year-on-year rate of inflation was 14.2% in August, averaging 12.4% during the first eight months of 2006. Food prices have remained well above medium-term averages, despite a series of good harvests, because of the rise in aggregate demand and market inefficiencies, and fuel-price increases have also put upward pressure on prices. We expect food price pressure to ease from the fourth quarter of 2006 if expectations of a super-bumper harvest are realised. As a result, we estimate the rate of inflation in 2006 at an average of 12.2%, and forecast that it will ease to 8% in 2007 in the wake of a healthy 2006/07 harvest and a slight easing in world oil prices, and to 7.5% in 2008 as the pace of economic growth slows and world oil prices edge downwards—although the rate of price increase will be far higher if food harvests fail.

Exchange rates

There was pressure on the official exchange rate in the first quarter of 2006 when the semi-official "parallel" rate dropped relatively steeply—reflecting uncertainty about donor inflows because of the political situation and a run-down of foreign-exchange reserves to pay for burgeoning imports, especially of oil—but the birr stabilised in the rest of the year as donors re-engaged under the protection of a basic services programme and export earnings grew robustly.

Although we expect strong growth in exports and remittances, the low level of foreign-exchange reserves remains a cause of concern. Foreign-exchange reserves remain under pressure, and ended June at US$1.1bn, 26% lower than a year earlier, and equivalent to less than three months of import cover. As a result we anticipate that the rate of depreciation of the birr will quicken slightly in 2007 and 2008, to nearer 1% per year, with the birr averaging Birr8.78:US$1 in 2007 and Birr8.90:US$1 in 2008. A sustained downturn in donor inflows because of political deterioration would lead to faster depreciation, although this scenario is not expected.

External sector

We estimate that Ethiopian exports rose quickly during 2006, driven by an expansion in sales of coffee (the number-one earner) in addition to robust growth in other export categories, notably oilseeds (dominated by shipments of sesame seed to China), gold, and leather and associated products. The export-based horticulture sector, especially flowers, also posted rapid growth, as did sales of meat and live animals. However, stronger import growth has widened the trade deficit and we expect the current-account deficit to expand to 16.3% of GDP in 2006.

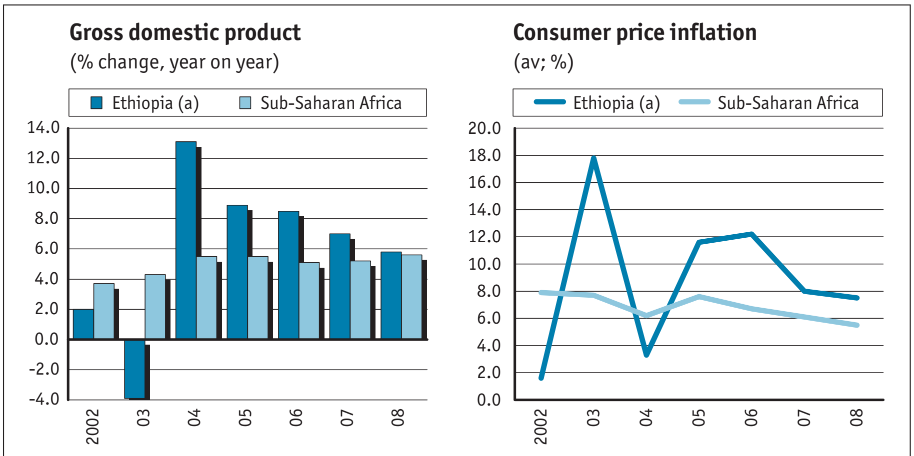
Export growth is expected to remain robust in 2007 and 2008, with sales of coffee and other key commodities posting solid increases. However, import growth will remain strong as large capital projects continue to drive import demand. As a result, the trade deficit is expected to widen throughout the forecast period. This will combine with a growing services deficit, owing to rising trade-related costs. Although we do not expect a "doubling of aid" scenario to materialise during the forecast period, current transfers (both official and private) are forecast to rise as donor relations continue to improve and donor-funded projects increase. Overall, we forecast that the current-account deficit will remain substantial, at 16.5% in 2007 and 16.4% in 2008.

Forecast summary

(% unless otherwise indicated)

	2005[a]	2006[b]	2007[c]	2008[c]
Real GDP growth[d]	8.9[b]	8.5	7.0	5.8
Consumer price inflation (av)	11.6	12.2	8.0	7.5
Lending interest rate (%)	7.0	7.3	7.3	7.5
Government balance (% of GDP)	-6.1[b]	-5.2	-5.7	-6.0
Exports of goods fob (US$ m)	917.3	1,114.6	1,191.3	1,280.1
Imports of goods fob (US$ m)	3,700.8	4,274.3	4,618.6	4,919.1
Current-account balance (US$ m)	-1,567.8	-1,930.5	-2,223.8	-2,470.1
Current-account balance (% of GDP)	-16.1[b]	-16.3	-16.5	-16.4
External debt (year-end; US$ m)	5,679.5[b]	2,795.0	3,191.8	3,589.6
Exchange rate Birr:US$ (av)	8.67	8.69	8.78	8.90
Exchange rate Birr:¥100 (av)	7.87	7.48	8.36	9.13
Exchange rate Birr:€ (av)	10.79	10.91	11.94	12.04
Exchange rate Birr:SDR (av)	12.81	12.79	13.62	13.88

[a] Actual. [b] Economist Intelligence Unit estimates. [c] Economist Intelligence Unit forecasts. [d] Fiscal years ending July 7th.



(a) Fiscal years ending July 7th.

The political scene

Almost 200 people are killed in post-election violence

The final official report of the commission of inquiry into post-election violence in June and November 2005 (July 2005, The political scene; January 2006, The political scene) admits that 199 people were killed (including six policemen), mainly as a result of gunfire, and that about 30,000 people were arrested. This compares with the previous official death toll of about 60, and an unofficial toll, cited by the media, of about 85. The report was commissioned by parliament in January 2006, and reported to parliament in October, several months later than planned. In a controversial judgement, however, the report absolves the security forces of using "excessive force", describing their actions as broadly appropriate to the needs of defending national security. The report nevertheless concedes that some human rights abuses took place (without elaborating) and recommends that security forces receive proper riot training.

Leading member of inquiry denounces final report

According to the former deputy chairman of the inquiry, Judge Wolde-Michael Meshesha, the inquiry's final report was a watered down version of the original draft. The jurist fled to the UK in October 2006 and leaked a copy of the draft version to the press, citing pressure to amend the draft, including death threats, as his reason for fleeing. The death toll was the same in both reports, but the draft accused the security forces of using excessive force (by an 8-2 margin, in a vote among inquiry members), whereas the final version did not. The original chairman of the inquiry, Firehiwot Samuel, has also left the country, and a third member of the inquiry may have followed. Only five of the original ten-strong team were present at the unveiling of the official report, although the new chairman, Mekonnen Disasa, defended the findings.

The opposition in parliament—including the United Ethiopian Democratic Front (UEDF), the Oromo Federalist Democratic Movement (OFDM) and the Coalition for Unity and Democracy Party (CUDP)—rejected the report's conclusion that excessive force was not used. Opposition officials were also angry about being denied access to the report before it was published, as had been promised. One positive aspect to the affair is that the report was subject to a debate and vote in parliament—although the government has a comfortable majority and acceptance of the report's findings by parliament was never in doubt: a motion to reject parts of the report was voted down by 276 votes to 116.

A defecting judge highlights human rights abuses

A senior judge, Teshale Aberra, the president of the Oromo Supreme Court, fled to the UK in late October 2006 seeking asylum, citing threats and harassment. He also accused the government of being responsible for "thousands" of killings since coming to power in 1991, especially in Oromia, and talked of a "systematic massacre". Mr Teshale further claimed that illegal detention and torture were commonplace, and that the government was currently engaged in appointing a swathe of friendly judges. The judge's flight is the latest in a series to have taken place in recent months, including from the military and the diplomatic service (October 2006, The political scene). More recently, Getachew Jigi, a member of the OFDM executive committee and an opposition member of parliament, left the country in November alleging a "reign of terror" and moves towards dictatorship. The secretary-general of the Council of People's Representatives, Foto Bedane, is also reported to have fled. Most defectors are sympathetic to the Oromo complaints of oppression and marginalisation, and in some cases to the outlawed Oromo Liberation Front (OLF), which is attempting to step up its ten-year military campaign against the government.

Ethiopia expels EU workers for helping an alleged dissident

Ethiopia expelled two EU officials (Bjorn Jonsson, a Swede, and Enrico Sborgi, an Italian) in October 2006 for allegedly trying to smuggle a local EU employee, Yalemzewd Bekele, out of Ethiopia after she became the subject of an arrest warrant for supposedly distributing opposition literature (in the form of a calendar). She initially took refuge in EU premises, but was stopped while trying to cross the border with Kenya and arrested. Ms Yalemzewd was released a week later, physically unharmed—although she complained of sleep deprivation—which forestalled a potentially more serious rift in relations with the EU. The affair clearly illustrates, however, how closely foreign diplomats are being watched at present by the government, after some missions failed to appear neutral in local politics during the election disputes of 2005.

The trial of key opposition leaders is moving very slowly

The trial of about 100 people, including several key leaders of the opposition Coalition for Unity and Democracy (CUD) and members of civil society, resumed in October 2006 after a near-three-month break. They are still charged with a range of serious offences relating to last year's post-election violence, including treason, which carries the death penalty, and remain incarcerated at Kiliti prison outside the capital, Addis Ababa. Some—including Daniel Bekele and Netsannet Demissie of Action Aid, a non-governmental organisation—have alleged mistreatment in prison (including sleep deprivation, overcrowding and lack of food), and the judge has ordered that their conditions be improved.

Despite government promises that the trial would be speedy, the opposite has been the case, with legal proceedings being marked by frequent adjournments. The state prosecutor picked up his case again in October—having spent the May to July period presenting audio and video evidence—by starting to call witnesses, all of whom have been granted anonymity. Over 70 witnesses had testified by early December, entirely in the government's favour, out of a list of 380, before the case was adjourned until February 19th 2007. Other witnesses may not be called, as the prosecutor appears to believe that he has built a sufficiently robust case and that little new can be added. The defence has 15 days to respond to the prosecution case, but is unlikely to do so (except in the case of three people) as most of those indicted do not recognise the authority of the court and have refused to plead. The trial has now been under way for a year—it started in December 2005—and may last for several more months, to the detriment of sociopolitical normalisation. A guilty verdict could spark new protests, although security remains tight throughout the country.

Ethiopia and Eritrea reject new border proposals

In an attempt to break the deadlock over the demarcation of the disputed border, the Ethiopia-Eritrea Boundary Commission (EEBC—an independent body under UN auspices) put forward a new proposal in early November 2006, based on delineating the border on official maps—using digital aerial photography—to reflect the EEBC's border ruling (June 2002, The political scene), even though demarcation on the ground is not possible because of the impasse between the two states. Ethiopia is concerned about the prospective loss of sensitive territory (including the border town of Badme), despite saying that it agrees "in principle" with the EEBC ruling, while Eritrea refuses to engage in any process that would change the EEBC's original decision. Not surprisingly, both protagonists reacted angrily to the EEBC's latest plan, Ethiopia because it believes the EEBC to be acting outside of its mandate (and because it still hopes to change the border ruling), and Eritrea because of the implied further delay to actual demarcation. Both countries refused to send representatives for talks with the EEBC on the matter. In response, the EEBC has given the two sides an additional 12 months to resolve their differences, after which the map amendment plan will be enacted with or without their approval. This would enable the EEBC to finish its work and be dissolved.

Troop movements boost tensions along border

Tensions climbed in October 2006 as Eritrea moved 1,500 troops (and tanks) into the demilitarised zone, evicting a platoon of peacekeepers from the UN Mission in Ethiopia and Eritrea (UNMEE) in the process. Eritrea claimed that they were engaged in harvesting and development work on sovereign territory, but the UN described the movement as a "major breach" of the Algiers peace agreement. Ethiopia has not responded to the provocation—the prime minister, Meles Zenawi, dismissed it as a minor matter—although the UN Security Council and the US have called for the troops' withdrawal. It is not yet clear if Eritrea has complied.

Ethiopia may go to war against Islamic forces in Somalia

Tension remains high in Somalia, where the weak transitional federal government—the internationally recognised legal authority, based in Baidoa—is pitted against the Union of Islamic Courts (UIC), which by late 2006 had taken control of most of southern Somalia. The transitional government is virtually powerless, but is supported by Ethiopian forces. Mr Meles has said that Ethiopian soldiers are there for training purposes only, but there is little doubt that several thousand Ethiopian troops (including tanks) are ranged along the border, and some are probably inside Somalia. For its part, the UIC has declared a "holy war" on Ethiopian forces in its territory, and is attempting to build military capacity with the backing of Eritrea (which seeks to oppose Ethiopia in any way it can, despite having little in common with the Islamists) and some Arab states, according to UN research.

It would take little to push situation over the edge

Heavy flooding towards the end of 2006 has limited troop movement, but the risk of war remains high. Mediation continues under the auspices of the African Union (AU) and the Intergovernmental Authority on Development (IGAD, a regional body), but little headway is being made, especially because of the UIC's opposition to the deployment of African peacekeepers. Ethiopian and UIC representatives—including Ethiopia's deputy foreign minister, Tekeda Alemu—held direct talks in Djibouti in early December 2006, but the chances of compromise seem slight. In mid-December the UIC issued a new ultimatum calling for all Ethiopian troops to be withdrawn from Somali soil, otherwise the UIC will begin to attack Ethiopia directly along the border. This would provide Ethiopia with a clear justification for sending troops into Somalia in the name of national defence.

Open conflict would destabilise the region

In late October 2006 the Ethiopian parliament voted (with 311 in favour and 99 opposed) to give the government the legal authority to defend Ethiopian interests. Most of the opposition voted against, despite being strongly nationalist, as they did not want to follow a government-dictated agenda. The UIC's declaration in favour of an ethnic Somali state, including the Somali region of Ethiopia, is helping to unite Ethiopians across the spectrum. A prolonged military conflict could be devastating for the region, creating floods of refugees, and perhaps sparking a wider conflagration and reigniting the Ethiopia-Eritrea conflict (reports suggest 2,000 Eritrean troops are in Somalia to back the UIC). Ethiopian forces probably have sufficient capacity to overcome the UIC in Somalia, but a bitter and costly guerrilla war—and continued regional instability—would be the likely consequence.

US warning of possible terror attacks

The heightened tension in Somalia and the alleged link between the Union of Islamic Courts (UIC) and al-Qaida—the terror group allegedly sees Somalia as a "third front", after Iraq and Afghanistan—has raised the risk of terror attacks in Ethiopia. The US warned in early November 2006 that extremist elements from Somalia might carry out suicide attacks in Ethiopia (as well as in Kenya and "surrounding countries"). The US warning was apparently based on intercepted letters from Sheikh Hassan Dahir Aweys of the al-Ittihad group, who is a prominent player in the UIC. Ethiopia's strategic value to the US in the war against terror is helping to shield the country from sanctions, which have been threatened by Congress because of the deterioration in the human rights situation. To cement security co-operation, the US embassy in the capital, Addis Ababa, opened the Africa Centre for Strategic Studies, a security "think-tank", in early November, the first branch of a planned continent-wide network.

Economic policy

The prime minister sacks the auditor-general

In a worrying development for fiscal probity, the prime minister, Meles Zenawi, sacked the long-standing federal auditor-general, Lema Argaw, on November 10th 2006, accusing him of interfering in politics. Mr Lema, who had been in place since 1979, reported in July 2006 that federal outlays of Birr4.8bn (US$550m) that were allocated to regional governments in the 2003/04 financial year—equivalent to about 36% of total federal outlays in that year—could not be adequately accounted for. The prime minister reacted angrily, claiming that regional governments were free to "burn" the money they received in federal subsidies if they chose to do so. Mr Meles's rationale is that regional auditors, not the federal auditor, are responsible for auditing regional spending. Mr Lema's sacking raises several concerns:

- it breaks the rule stating that the auditor-general can be sacked only by parliament (although there is no doubt that Mr Meles could have raised the necessary majority had he chosen to go down this route);
- it suggests that constitutional provisions granting independence to the auditor-general, dating from 1997, carry little weight; and
- it will alarm the donor community, which has rechannelled support from the federal government to regional governments under the protection of basic services (PBS) programme in response to the crackdown on the opposition after the May 2005 election (July 2006, Economic policy).

The World Bank is to review the new PBS programme

The switch by donors from direct support for the federal budget to the PBS programme has raised concerns about how effectively the money—worth about US$420m over two years (2006/07 and 2007/08)—is being spent. The sacking of the auditor-general, seemingly for exposing financial mismanagement at a local level, will have done nothing to relieve donor worries. The World Bank has promised strict monitoring of the PBS, however, and initiated a first quarterly assessment of the programme in October 2006 (covering July-September), which is due to be delivered before the end of the year. A final quarterly review is scheduled to take place in April 2008. The PBS will be assessed according to four main parameters: a fairness review (to ensure that all regions receive their proper entitlement); an accountability review (to ensure that the programme is responsive to local needs); an additionality review (to ensure that donor funding supplements federal funding rather than replacing it); and a fiduciary review (to ensure that all funding is properly accounted for). A failure to meet required standards in any of the four areas could lead to funding being suspended. A return to direct budget support will remain conditional on a return to political normality.

External funding remains solid in the current financial year

Donor support for Ethiopia is largely unwavering, despite the political setbacks. The Ministry of Finance and Economic Development expects to receive a total of Birr16.5bn (US$1.9bn) in external funding in the 2006/07 financial year, Birr8.5bn from multilateral sources and Birr8bn from bilateral sources, with about 50% of the total in grant form. Funding in the first quarter of the financial year comprised Birr142m in bilateral grants and Birr2.7bn in loans and grants from multilateral sources, principally the World Bank (for roads and electricity). The figure for external funding in 2006/07 includes an anticipated sum of Birr1.8bn stemming from debt cancellation (leading to lower repayments).

In the latest developments:

- France approved funding of €80m (US$106m) in November 2006, covering 2006-10, with 80% of the sum earmarked for water, sanitation and urban development;
- the EU approved a €155m grant in October 2006, covering a three-year period, for the road sector development programme; and
- the UN announced funding of US$722m in October 2006, covering a four-year period, to be channelled through the UN Development Programme (UNDP), the UN Children's Fund (UNICEF) and the UN Population Fund (UNFPA).

Ethiopia posts a small decline in perceived corruption

Perceived corruption fell slightly in Ethiopia in 2006, according to Transparency International, a Berlin-based non-governmental organisation, although the country remains in the category of "rampant" corruption. Ethiopia's score on the corruption perceptions index—where zero is totally corrupt and 10 totally clean—climbed to 2.4 in 2006 from 2.2 in 2005. This pushed Ethiopia up the world rankings to 130th position (out of 163 countries) from 137th in 2005, placing it on a par with Burundi, the Central African Republic, Togo and Zimbabwe (in Sub-Saharan Africa) and Azerbaijan, Papua New Guinea and Indonesia (on the world list).

Corruption Perceptions Index 2006: selected countries in Sub-Saharan Africa

Country	2006 ranking[a]	2006 score[b]	2005 score[b]	2004 score[b]
South Africa	51	4.6	4.5	4.6
Tanzania	93	2.9	2.9	2.8
Eritrea	93	2.9	2.6	2.6
Mozambique	99	2.8	2.8	2.8
Uganda	105	2.7	2.5	2.6
Ethiopia	**130**	**2.4**	**2.2**	**2.3**
Zimbabwe	130	2.4	2.6	2.3
Kenya	142	2.2	2.1	2.1
Nigeria	142	2.2	1.9	1.6

[a] Out of 163 countries. [b] Zero indicates totally corrupt; 10 indicates totally clean.

Source: Transparency International, *Corruption Perceptions Index*.

Ethiopia's improvement in 2006 perhaps reflects heightened activity by the Federal Ethics and Anti-Corruption Commission (FEACC). In one of the major cases of 2006, 12 senior officials of the Development Bank of Ethiopia (DBE) were arrested in May and subsequently charged with advancing loans in violation of bank policy (in particular a Birr87m—US$10m—loan made to a private firm, Addis Industrial, in 2005) and, in some cases, of illegal foreign-exchange transfers overseas. Charges against six of the 12 defendants were subsequently dropped at a hearing in August, and five were released on bail, although one (Moges Chemere, a former president of the DBE) was kept on remand—bail is possible under anti-corruption laws only if the likely sentence is less than ten years in prison. Nevertheless, despite FEACC's higher profile, the suspicion persists that the institution is not truly independent (a claim that FEACC rejects) but is sometimes used by Mr Meles as a vehicle to emasculate his political opponents.

New software for tax authorities

The Federal Inland Revenue Authority (FIRA) installed a new tax administration system in October 2006, known as the Standard Integrated Government Tax Administration System (SIGTAS), in an effort to improve the efficiency of revenue collection. The system, which cost Birr1.4m (US$159,000), is now operating in the Large Taxpayers Office and the Addis Ababa office, and will be rolled out to other centres—including Bahir Dar, Mekele, Nazareth, Awassa, Jimma and Dire Dawa—by the end of the year. All tax information will now be held on a single database, and both federal and regional authorities will be allowed to access it, potentially improving co-operation between different tax agencies. Some companies are complaining, however, about the large increase in paperwork required under the new system. Tax collection is improving slowly, helped by economic growth and better administration. In the first quarter of fiscal year 2006/07 (starting July 8th), the Ministry of Revenue and Income reported receipts of Birr3.23bn (US$368m) from FIRA, the Ethiopian Customs Authority (ECA) and the National Lottery Administration—nearly 100% of the target and 3.1% higher than the year-earlier period.

The domestic economy

Economic trends

The 2006/07 harvest is likely to be a bumper one

With agriculture generating almost half of GDP (48.2% in 2004/05), the performance of the farming sector is clearly the main determinant of GDP growth. Farm production, in turn, is largely determined by the weather. On this basis, prospects for agriculture and overall GDP growth in 2006/07 are positive. Good early rains in the second quarter of 2006, which encouraged planting, were followed by exceptionally good rains in the third quarter. This is expected to produce a bumper *meher* cereal harvest, which is gathered between October and January (and which accounts for 90% of annual production). Official estimates of the size of this season's harvest will not be produced until January 2007 (following an assessment in December 2006), but initial indications are encouraging, according to the Famine Early Warning System Network (Fewsnet). Food production has also been boosted by the persistence of above-average producer prices and the absence of serious pest infestations.

Mid-year flooding has not hit production

Severe flooding in July and August 2006 followed by renewed flooding in eastern areas in October and November, although devastating in some localities, will not have much impact on farm output. The extra rainfall has, in fact, proved largely beneficial, and initial harvesting of the *meher* crop has not been affected, according to field reports. Suitably dry weather is forecast for the rest of the harvest period in the main cropping areas, and pulse production will benefit from good soil moisture content.

Number needing food assistance will fall in 2007

The numbers in need of emergency feeding will therefore fall in 2007, from about 3m in 2006. A good farm season will also boost the smaller industrial and service sectors—especially activities linked to agro-processing and agro-marketing—and the Economic Intelligence Unit continues to forecast growth of

7% in real terms in 2006/07, a fourth consecutive year of rapid expansion. However, although this is an impressive sequence, the true test of how well Ethiopia's economy is developing will come when the next drought strikes, as it inevitably will.

Ethiopia's slide down world competitiveness rankings

Despite robust growth and structural reform in recent years, Ethiopia's business environment remains challenging and the private sector small. This is captured by the latest Growth Competitiveness Index (GCI) for 2006, produced by the World Economic Forum, which places Ethiopia in 120th position out of 125 countries, down four slots from 2005, with a score of 2.99 out of 7.00, compared with 3.00 in 2005. The GCI index is based on several variables including the macroeconomy, institutional capacity, infrastructure, health and education, and market efficiency.

Higher food and oil prices continue to drive inflation

Inflation remains at a moderately high level, according to the latest data from the National Bank of Ethiopia (NBE, the central bank). The annual average rate of inflation remained at 12.4% in the 12 months to August 2006 (compared with the preceding 12-month period), comprising a 13.7% rise in food prices and an 8.8% rise in non-food prices. More recent official figures are not yet available, although information from Fewsnet suggests that cereal prices remained much higher than the 2001-05 average (and higher than the level in 2005) in August-October 2006, although they declined slightly in October (at least in the market in the capital, Addis Ababa) as the *meher* harvest started. The steady rise in non-food inflation in the first seven months of 2006 reflects higher world oil prices, although the figures do not incorporate the most recent rise in local fuel prices, of 20%, which was implemented in August.

Inflation, 2006
(% change)

	Mar	Apr	May	Jun	Jul	Aug
Annual average	12.0	12.0	12.3	12.3	12.3	12.4
Food	14.2	14.2	14.4	14.0	13.8	13.7
Non-food	7.2	7.2	7.6	8.1	8.4	8.8
Year on year	11.2	9.5	13.7	11.6	13.5	14.2

Source: National Bank of Ethiopia.

The persistence of high food price inflation despite a series of bumper harvests is explained by several factors, including: higher overall demand, especially in rural areas (driven by rising household income), which has constrained the amount reaching markets; government policies that seek to maintain healthy producer prices (to encourage production); a switch by some farmers into potentially more lucrative cash crops (such as sesame); and market inefficiencies, such as a poor transfer of information from one regional market to another.

New commodities exchange planned, to improve efficiency

The government aims to address the problems of market efficiency by setting up an Ethiopian Commodities Exchange (ECEX), which is tentatively scheduled to start operating in September 2007, in time for the main 2007/08 harvest. The plans call for a fully automated computerised system, listing prices for key farm commodities—including coffee, sesame, beans, teff, wheat and maize—on a daily basis. Prices will be derived from ten key markets throughout the country, including Addis Ababa—the largest—that will be linked electronically. Apart from the main exchange, there will be 20 other trading sites, while 200 information boards in smaller rural markets will be connected to the system. ECEX is an ambitious undertaking, but has the potential to improve linkages between markets greatly, helping to create a more stable "national" market, to the benefit of both consumers and producers. One key requirement will be the establishment of an independent and effective exchange regulator, to minimise the risk of price manipulation. A high-level Ethiopian delegation, led by the deputy prime minister, Addisu Legesse, visited India in October 2006 to study the operation of the Indian Multi Commodity Exchange (MCX).

Agriculture

Ethiopia and Starbucks fail to reach trademarks agreement

Ethiopia, the birthplace of coffee, is in dispute with Starbucks, a giant US coffee retailer, over Ethiopia's drive to trademark certain local coffee varieties in an attempt to gain greater control over marketing and thereby boost farmers' income. The dispute came to the fore in October 2006 following claims by Oxfam (a UK-based anti-poverty non-governmental organisation) that Starbucks was effectively blocking an attempt by Ethiopia to trademark three varieties of coffee—sidamo, harar and yirgacheffee—thereby costing the state US$88m in lost annual earnings. Ethiopia applied for the trademarks in several countries in 2005, but although European, Japanese and Canadian authorities have approved them, the US Patent and Trademark Office (USPTO) has been holding out. The USPTO blocked the application for sidamo and harar in August 2006 following protests by the National Coffee Association (NCA, a US trade body) on the grounds that the names were generic terms. Oxfam claims that Starbucks, which sells coffee under these Ethiopian names, persuaded the NCA to take an obstructive stance, although Starbucks denies applying any pressure.

Starbucks propose a regional certification scheme

The most important question, however, is whether or not trademarking is the best way for Ethiopia to boost coffee value-added—the answer is not clear-cut. Starbucks is proposing the alternative of regional certification (like the one under which Jamaican "Blue Mountain" coffee is successfully marketed, which earns local growers 45% of the final retail price, compared with 5-10% in Ethiopia) and believes that Ethiopia's attempt to trademark coffees will result in lost sales, because it will raise prices, and because buyers may be wary of getting embroiled in legal disputes. However, setting up any scheme—be it regional certification or trademarking—will be difficult in Ethiopia because most coffee is grown by large numbers of widely dispersed and poorly connected smallholders. Any system would need to be properly enforced, or else it would lose its value. In this regard a certification scheme might be better as it would easier to enforce.

In late November 2006 Starbucks' managing director, Jim Donald, flew to Addis Ababa for talks on the issue with the prime minister, Meles Zenawi, but no agreement was reached. Ethiopia insists that it wants to push ahead with trademarking, and was even prepared to offer Starbucks free use of the trademark provided that the company accepted the principle, but Starbucks remains unbowed, although it says that it is committed to finding a solution.

Coffee production and exports
('000 tonnes unless otherwise indicated)

	2000/01	2001/02	2002/03	2003/04	2004/05
Production[a]	221	245	250	260	300
Domestic consumption	100	110	110	110	110
Exports[a]	85	116	137	142	172
Export earnings (US$ m)[b]	182	163	165	224	335
% of total exports	39	36	34	37	41

[a] Coffee marketing years (October to September). [b] Fiscal years ending July 7th.

Sources: Ethiopian Coffee and Tea Authority; National Bank of Ethiopia.

Financial and other services

Private banks post higher profits and earn awards

Most of Ethiopia's six private banks recorded significant profit rises in the 2005/06 financial year (ending June 30th), reflecting the booming economy, with Dashen Bank leading the pack. However, access to precious foreign exchange remained challenging, given the dominant position of the state-run Commercial Bank of Ethiopia (CBE), especially in the foreign-exchange market. Dashen earned a net profit of Birr133.6m (US$15.4m) in the 2005/06 financial year—a record for a private bank in Ethiopia and almost double the level in 2004/05. Gross profit amounted to Birr185.3bn (US$21.3bn) and tax paid to Birr51.7bn. Dashen, which has 37 branches, increased lending by 41% to Birr3.1bn, and deposits by 32% to Birr3.7bn in 2005/06 compared with a year earlier. The number of depositors rose by 21%, to almost 338,000, while activity was boosted by a link-up with the Visa credit-card network. However, Dashen acknowledges complaints about payment delays, attributing the problem to periodic failures of its broadband Internet connection. Provision for bad debts also increased (by 17%, to Birr84m), although non-performing loans account for a relatively small 6.2% of the bank's loan portfolio.

NIB Bank, the newest private bank (established in 1999), perhaps had the most to be pleased about, however, following its receipt in November of the "Ethiopian Bank of the Year 2006" award from the *Global Finance* journal, which follows a similar award in 2005 from another journal, *The Banker*. NIB's net profits in 2005/06 jumped by 24% year on year, to Birr56.6m (in a report approved by international auditors). Total lending rose by 30% to Birr1.5bn. About two-thirds of NIB's income comprised interest earned on loans and advances, and the other third (down slightly from 2004/05) was generated by foreign operations—mainly the handling of remittances, a market that all local banks are keen to tap. NIB also entered *African Business* magazine's list of Africa's 100 top banks in 2006, joining CBE and Dashen.

Ethiopian Airlines reports higher traffic but lower profits

The national carrier, Ethiopian Airlines (EAL)—an autonomous state-owned body—recorded a sharp fall in profits, of 57%, in the 2005/06 financial year to Birr134m, despite pushing up passenger numbers by 13.5%, to 1.76m. The decline in profits reflects a sharp leap in costs, which rose by 26% to Birr5.28bn, partly because of a 36% rise in fuel charges to Birr1.86bn. Total revenue rose more slowly, to Birr5.41bn, although it was 10% above target. Apart from fuel, other significant unplanned outlays in 2005/06 included the cost of leasing four extra aircraft (the first time that EAL has done this), from MacDonnell Douglas, in order to cope with strong demand, and a payment of Birr155m towards five additional Boeing 787 "Dreamliners" (on top of the previously confirmed order for five, taking the total to ten). EAL was prepared to sacrifice profit to the cause of maintaining market share and building future capacity. The company forecasts a recovery in profits, to Birr307m, in 2006/07 on the back of a sharp rise in passenger numbers, to 2.9m, and higher freight traffic. EAL's good performance (despite the dip in profits) was recognised by the conference organised by *African Aviation* (a journal) in Cape Town, South Africa, in October, which named the Ethiopian carrier as "African Airline of the Year 2006". One constraint being faced by the airline, however, is the dire shortage of hotel space for transit passengers. As a result, EAL plans to invest US$30m in a new four-star hotel in Addis Ababa, to cater for this market. At present, the airline books about 200 rooms a day in other hotels in the capital.

Airline freight capacity is on the rise

Driven by demand from Ethiopia's horticulture and meat producers, air freight capacity is rising. EAL commissioned a new cargo plane in October 2006—a Boeing 757 that formerly carried passengers—and now has two planes dedicated solely to freight. A third is likely to be leased between January and May 2007 (the peak horticultural season). Even prior to the new addition, air freight volumes were showing a solid rise, with meat shipments up by 27% (by volume) in the first quarter of 2006/07 (July to September 2006), compared with a year earlier, and with flower export earnings up significantly, to US$7.3m, for the quarter (although this was below expectations, partly because of a shortage of freight capacity). During 2005/06 Ethiopia exported approximately US$23m of flowers, US$14m of other horticultural products and US$35m of live animals and meat, and hopes to improve on these figures in 2006/07, especially for flowers.

Air freight capacity in Ethiopia has also been augmented by the entry of Etihad (Abu Dhabi) into the market in late 2006. The carrier has raised the amount of freight transported per flight from 15 tonnes to 40 tonnes since it began operations. Other airlines flying to Ethiopia, such as British Airways, Kenya Airways and Turkish Airways, are also competing for freight business, although EAL remains the major player and opened new storage facilities in May (July 2006, The domestic economy: Infrastructure). However, a plan by Sher, one of Ethiopia's largest flower producers, to introduce its own dedicated air cargo plane (leased from Dutch airline Laudan Airways and flying direct to Europe's main flower market in Amsterdam) appears to have been derailed by opposition from other flowers growers—represented by the Ethio Horti Share Company (EHSC), a shipping broker—who are showing patriotic attachment to EAL (noting the airline's loss-making support for growers when the flower business was still at an embryonic phase). Sher, set up by Dutch investors, appears to have conceded defeat, at least temporarily, until it is clear whether EAL can cope with extra demand or not. The Sher plan was also facing resistance from the Ethiopian Civil Aviation Authority, which said that flights would be approved only on a temporary basis. Sher planned to offer a competitive rate of US$1.65/kg, fixed throughout the year, compared with the variable US$1.40-1.70/kg rate offered by the EHSC, depending on the season and available capacity. By contrast, Etihad charges US$1.70/kg, British Airways US$1.80/kg and Turkish Airways US$2.10/kg.

Foreign trade and payments

The current-account deficit rises sharply in 2005

New figures in the IMF's *International Financial Statistics* show that Ethiopia's current-account deficit more than doubled, to US$1.57bn, in 2005, largely because of a surge in imports and import-related services costs. Exports grew by a robust 35%, to US$917m, but imports kept pace, expanding by 34%, to US$3.7bn, leading to a much higher trade deficit. Imports were driven by higher world oil prices and strong demand for capital equipment for donor- and state-funded infrastructure projects. The rise in imports is also reflected in higher service outlays, which pushed the services balance heavily into deficit for the first time in several years—by US$182m—despite a slight rise in service inflows. The income account deficit fell steeply to just US$5m in 2005, because of debt relief, but the current transfers surplus was static at US$1.4bn, reflecting donor unease following post-election violence. The overall "invisible" balance fell from US$1.42bn in 2004 to US$1.22bn in 2005, and combined with higher imports to push the current-account shortfall higher. Financial and capital inflows (in the form of foreign direct investment—FDI—and loans) moved up strongly, however, trimming the overall balance-of-payments deficit to US$323m. Notably, errors and omissions remain at a high level, although were positive in 2005, in contrast to the previous three years.

Current account
(US$ m unless otherwise indicated)

	2002	2003	2004	2005
Exports (fob)	480	496	678	917
Imports (fob)	-1,455	-1,895	-2,768	-3,701
Trade balance	**-975**	**-1,399**	**-2,090**	**-2,784**
Services balance	5	53	47	-182
Income balance	-23	-24	-29	-5
Current transfers balance	856	1,233	1,404	1,402
Current-account balance	**-137**	**-136**	**-668**	**-1,568**
Financial & capital balance	-83	247	73	759
Errors & omissions	-915	-390	-354	486
Balance of payments	-1,134	-280	-949	-323

Source: IMF, *International Financial Statistics*.

Foreign direct investment falls steeply in 2005

FDI into Ethiopia fell by more than one-half in 2005, to US$205m (from a record US$545m in 2004), according to the latest *World Investment Report* from the UN Conference on Trade and Development (UNCTAD). The decline undoubtedly reflects the political turbulence that followed the disputed elections in May 2005. However, there is considerable uncertainty about levels of Ethiopian FDI. The IMF, for example, in its last country report (dated May 2006) recorded FDI of US$100m-150m a year in the 2001/02 to 2004/05 financial years, rising to US$170m in 2005/06, which broadly concurs with figures from the National Bank of Ethiopia (NBE, the central bank). It is not clear where UNCTAD's much higher figures come from, but the discrepancy partly reflects statistical weakness in Ethiopia. Notably, the new UNCTAD report highlights that Ethiopia is a key recipient of FDI from the category of "developing and transition" economies, which accounted for 51% of FDI into Ethiopia in 2002-04. This illustrates the prominent role played by Saudi Arabia's Sheikh Mohamed Al-Moudi, who is acknowledged to be Ethiopia's largest foreign investor, and his Mohamed International Development Research Organisation Companies (MIDROC). Ethiopia has also secured FDI from non-traditional sources such as China, India, Turkey, Iran and Slovakia.

Foreign direct investment into Sub-Saharan Africa
(US$ m)

	2003	2004	2005	Stock 2005
Tanzania	527	470	473	6,029
Uganda	202	222	258	1,830
Ethiopia	**465**	**545**	**205**	**2,752**
Kenya	82	46	21	1,113
Total FDI into Sub-Saharan Africa	13,137	11,294	17,934	179,216

Source: UN Conference on Trade and Development, *World Investment Report 2006*.

As part of the effort to boost FDI, the government established the National Foreign Investment Advisory Council in October 2006, chaired by the trade and industry minister, Girma Birru, and deputy-chaired by the director of the Ethiopian Investment Agency, Abi Woldemeskel. The council also includes representatives from other ministries, the Privatisation and State Enterprises Supervising Agency (PPESA) and private companies (both foreign and local). The council has been tasked with finding over 40 foreign investors in the 2006/07 financial year, including ten in agro-processing, ten in horticulture, 15 in textiles and garments, and the rest in shoes. Notably, the composition of the council is designed to offer expertise (and facilitate practical arrangements) in several key areas including land acquisition, financing and the provision of infrastructure. The council also plans to identify countries with a propensity to invest in Ethiopia and to target companies in those countries via representations from Ethiopian diplomats. The council met for the first time on November 2nd 2006 and plans to convene every two months.

New round of tariff cuts planned

In November 2006 the Ministry of Finance and Economic Development announced that a new round of tariff cuts would take place in 2007, the seventh since liberalisation started in 1993, and the first since the maximum import tariff was trimmed to 35% in January 2003. The latest cuts are likely to leave the top rate, which applies to finished goods, unchanged, but will instead focus on reductions for raw materials and intermediate goods, especially for emerging industries. The finance ministry is expected to submit detailed proposals to the Council of Ministers in January 2007.

Ethiopia takes an important step towards joining the WTO

In November 2006, after a two-year delay, the Council of Ministers finally submitted its Memorandum on the Foreign Trade Regime (MFTR)—which outlines the country's trade policies, laws and regulations—to the World Trade

Organisation (WTO). Ethiopia applied to join the WTO in January 2003 and a working party was established a month later to consider the application, but it has been unable to meet to date because of Ethiopia's failure to submit the MFTR. An Ethiopian technical committee prepared the document in 2004, before handing it over to the Council of Ministers in October of that year, but the process was stalled until the latest breakthrough. The WTO's working party on Ethiopia is expected to start meeting in 2007, but negotiations are unlikely to move forward quickly because of the large number of local laws that will need to be overhauled to meet WTO requirements. Ethiopia is not expected to complete the membership process until 2012.

One reason for the government's delay in approving the MFTR was apprehension about meeting the WTO's requirement to open the banking system to foreign players. Foreign banks are currently barred because of the government's belief that local private banks will be unable to cope with the extra competition, at least until they are better developed. Just how much time will be needed for local banks to build sufficient capacity emerged as a key point of division. The prime minister, Meles Zenawi, is thought to oppose an early opening, whereas Mr Girma is believed to have a more liberal orientation (apparently noting that "the sector would not remain closed forever"). Given the sensitivity of the issue, Ethiopia is likely to seek special dispensation for the banking sector under WTO rules that allow protection to be maintained for an eight-year period, provided that Ethiopia can convince other WTO members of the merits of its case. Assuming that WTO membership does not take place until 2012, foreign banks could remain barred until 2020, although pressure is likely to build for protection to be dismantled earlier. Ethiopia is one of the few countries in Sub-Saharan African that has not admitted foreign banks.