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The Federal Democratic Republic of Ethiopia: Letter of Intent

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ETHIOPIA—LETTER OF INTENT

Addis Ababa, December 15, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington DC

Dear Managing Director:

The pursuit of growth-oriented policies crucial for poverty reduction, the direction of efforts at maintaining supportive macroeconomic stability, and the advancement of structural reforms have contributed to the Ethiopian economy making significant progress in recent years. Effective implementation of these policies has induced robust real GDP growth averaging 11.5 percent per annum during the last five years. The strong growth, sustained mainly by increased agricultural production, public-private investment in construction, manufacturing, power, tourism, and financial services, has contributed to significant poverty reduction and better prospects for the achievement of the MDGs. Agriculture will continue to be the major contributor to economic growth, given substantial investment in irrigation schemes, with non-agricultural sectors also playing an increasing role.

In the meantime, Ethiopia is facing the challenge of sustaining high growth as the slowing global economy dampens demand for and revenue from commodity exports. This situation is further compounded by increasing inflationary pressure, driven largely by high food and fuel prices. The annual average CPI inflation stood at about 15.8 percent in 2006/07 and increased to 25.3 percent in 2007/08. The inflation rate is expected to slow down during the course of 2008/09 owing to an envisaged good harvest and the prudent fiscal and monetary policies being pursued.

Unexpectedly high oil and fertilizer prices have also undermined the balance of payments. The rapid economic growth witnessed in recent years has been supported by strong exports, which have registered an annual average growth rate of 20.9 percent during the last two years. However, with import costs rising rapidly, the country's current account as well as the overall balance of payments deficit has widened and the international reserves have come under heavy pressure, dropping to about 6 weeks of imports of goods and services at end - November 2008.

Impact of the Shocks

In addition to the traditional concerns of ensuring fiscal prudence and debt sustainability, containing inflation, and sustaining growth, we thus have to find immediate solutions to the shock to the economy caused by high food, fertilizer and fuel import costs.

Let us elaborate further on the pervasive impact of these shocks and the challenges they pose. The inflationary hike, caused mainly by higher food prices and to a lesser extent by non-food inflation of commodities such as fuel, fertilizer and construction materials, is having a severe negative impact particularly on the urban poor as well as on overall economic performance. In turn, even with the more recent decline in world food, fertilizer and fuel prices, we see that a weak balance of payments will persist in the coming years. In 2008/09, emergency wheat imports of US\$182 million are needed to help stabilize domestic prices and reduce the impact on the poor. Imports of oil, even with the decline in price, will remain very high by historical standards at close to US\$1.5 billion.

Policies to Address the Shocks

To mitigate the impact of these shocks on Ethiopia's economy, the Ethiopian government has taken concerted fiscal, monetary and administrative measures and will continue to do so

- The government has eliminated the entire fuel subsidy in October 2008.
- In order to provide a more effective subsidy to the poor, we will continue to import grains and distribute them at cost through local markets.
- In the monetary area, minimum deposit interest rate was increased and reserve and liquidity requirements of banks raised to restrain domestic credit expansion and monetary growth. We intend to contain the broad money growth below 20 percent in the current fiscal year. To achieve this target, the National Bank of Ethiopia (NBE) has committed to maintain net claims of the domestic banking system on the general government at zero over the course of 2008/09.
- On the fiscal front, the government will continue to focus on maintaining the deficit at a sustainable level, while at the same time, increasing spending in key poverty-oriented sectors. For this current year, we have decided to tighten fiscal policy well beyond original budget intentions. To this end, the government is committed in its revised budget to not borrow domestically from the banking system on net basis in
- the current fiscal year compared with the originally budgeted level of domestic borrowing of 1.5 percent of GDP and domestic borrowing of 2.7 percent of GDP in 2007/08. To achieve this, considerable efforts are being made to mobilize domestic revenue and reduce lower priority expenditure.

- Along with lowering the government's ceiling on domestic borrowing, we will closely follow the activities of public enterprises and reduce their domestic borrowing to between 4–8 billion birr (no more than 2½ percent of GDP) in 2008/09. A committee comprising officials from the Ministry of Finance and Economic Development and the NBE will be established to conduct monthly follow up. It will closely monitor the domestic financing of public enterprises and other public institutions and inform high-level policymakers who will seek corrective actions if necessary.
- Regarding the external sector, the government has continued to create a conducive environment for enhancing exports and private remittance transfers. The Government is committed to introduce greater flexibility in the foreign exchange market and will continue undertaking structural reforms to improve productivity and external competitiveness.

The government stands ready to implement other policy measures should the shocks turn out to be worse than expected.

Request for Fund Assistance under the ESF

Despite the foregoing efforts, the challenge remains huge in the short run. Cognizant of the difficulties, development partners such as the World Bank and AfDB have come up with mechanisms to help mitigate these problems. So far, agreements have been reached with the World Bank to redeploy US\$137 million through restructuring the existing portfolio and to allocate new financing of US\$130 million. The AfDB is to redeploy US\$64 million in response to the food crisis and with the aim of improving domestic agricultural productivity in a sustainable manner, taking advantage of prevailing price incentives to promote an immediate supply response.

The challenges outlined above require urgent additional support. We therefore request that the IMF allow the Ethiopian government the maximum access of 25 percent of quota through the rapid access component of the Exogenous Shocks Facility (ESF) to help mitigate the problems. We intend to engage strongly with the Fund with respect to policy advice and have no intention of introducing or intensifying exchange and trade restrictions. We also will request an update of the safeguards assessment for the NBE.

With best regards,

_____/s/_____
Sufian Ahmed
Minister

_____/s/_____
Teklewold Atnafu
Governor