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Ethiopia: Letter of Intent, and Memorandum of Economic and Financial Policies

October 8, 2010

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
LETTER OF INTENT

October 8, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund

Dear Mr. Strauss-Kahn:

1. **The attached Memorandum of Economic and Financial Policies (MEFP) describes Ethiopia's performance in 2009/10 and policies for 2010/11**. The government of Ethiopia has implemented the policies contained in the economic and financial program supported by the 14-month arrangement under the High-Access Component of the Exogenous Shock Facility (HAC-ESF), approved by the IMF Executive Board on August 26, 2009.

2. **We request completion of the second review of the HAC-ESF arrangement and disbursement of the third tranche of the arrangement equivalent to SDR 40.11 million (30 percent of quota)**. All the quantitative performance criteria for July 7, 2010, were observed. The structural benchmarks were implemented.

3. **We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program**, but will take additional measures as needed to reach these goals. We will consult with IMF staff on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the agreed IMF policies on such consultations.

4. The Government of Ethiopia authorizes the IMF to publish the contents of this letter, and the attached MEFP, on its website after consideration of our request by the Executive Board.

Sincerely yours,

/s/
Sufian Ahmed
Minister
Ministry of Finance and Economic Development

/s/
Teklewold Atnafu
Governor
National Bank of Ethiopia

Attachment:
Memorandum of Economic and Financial Policies

ATTACHMENT I

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2010/11

October 8, 2010

I. INTRODUCTION

1. This memorandum:

   a. Reviews macroeconomic and financial performance under the program through July 7, 2010.

   b. Updates the MEFP of April 28, 2010, detailing our policy commitments through October 2010.

   c. Describes macroeconomic and financial policies for 2010/11.

II. ECONOMIC DEVELOPMENTS UNDER THE PROGRAM THROUGH JULY 7, 2010

2. The key objective of our economic and financial program for 2009/10—to make further progress on macroeconomic stability in the face of the difficult external environment—has been met. Macroeconomic conditions continued to improve while broad-based growth momentum has been maintained. Overall CPI inflation decelerated further to 5.7 percent (end-period) in July 2010; non-food inflation has declined only modestly to 18 percent. Thanks to strong external assistance (including the SDR allocation and ESF disbursement), strong export growth, and moderate import growth, international reserves rose to 2.1 months of import cover. All quantitative targets set for July 7, 2010, were met, with margins (Table 1). The structural measures covered by benchmarks were implemented (Table 2).

3. **Fiscal performance was well within program objectives**. Overall general government revenue is estimated to have risen strongly and expenditure was below target, resulting in domestic financing of only 1.8 billion birr, of which 0.8 billion birr from the NBE, against an adjusted program borrowing limit of 4.2 billion birr. The good revenue performance reflected the impact of strong economic growth, administrative efforts, and the lagged effect of inflation. Net external financing and grants were somewhat below projections.

4. **Monetary policy was consistent with the program objectives**. Reserve money growth was limited to 5.4 percent in the first half of 2010, against a program target of 9.2 percent, on account of lower credit extension to government by the NBE. On an annual basis, reserve money growth declined markedly to 6.5 percent from about 16 percent at end-2009. As a result, excess liquidity in the banking system was significantly reduced. T-bill rates have risen somewhat in

recent auctions. Broad money growth rose to 24 percent from 20 percent at end-2009, reflecting a significant increase in bank credit to the private sector, as credit ceilings were eased.

5. **The birr was allowed to depreciate by 16.5 percent (in foreign currency) on September 1**. This was aimed at removing any remaining overvaluation of the currency; boosting exports further by strengthening the country's external competiveness; promoting import substitution; and encouraging remittances. The contracting of non-concessional external loans of US$470 million was completed in late June (within the program limit) to finance infrastructure projects. No external payment arrears have been incurred during the period.

6. **Our structural reform agenda is being implemented as agreed**. A liquidity control framework is being implemented by NBE. The tax reform strategy is being implemented with the repeal of the exemptions on cement and some foods from the VAT, the review of exemptions, and the merger of the collection of taxes of Addis Ababa City with ERCA. A high level joint committee of the NBE and the Ministry of Finance and Economic Development (MoFED) staff has been monitoring borrowing by the public enterprises from the domestic banking system. An action plan to strengthen national account statistics was adopted in August 2010, based on technical assistance by the IMF's Statistics Department.

III. MACROECONOMIC POLICIES FOR 2010/11

7. **We remain committed to implementing the policies and meeting the quantitative and structural reform objectives described in our previous MEFP**. We are aiming at real GDP growth of about 11 percent in 2010/11, but maintain the conservative assumption for the purpose of the program of 8.5 percent in 2010/11. We aim to keep inflation in the single digits. The external current account deficit is expected to widen to 8.0 percent of GDP on account of a sizable increase in capital goods imports associated with new aircraft purchases and large hydro power investments. The gross official reserves coverage target at end 2010/11 is 2.3 months of imports. The macroeconomic priority for 2010/11 is to contain inflation, strengthen international reserves, and reform monetary policy to promote financial deepening. This will require limited domestic financing, consistent with the intention to contain reserve money growth, the vigorous implementation of tax reforms aimed at raising fiscal revenue. Sustained levels of concessional external financial assistance remain critical to our development needs.

Fiscal policy for 2010/11

8. **Fiscal policy in 2010/11 aims at continuing our strong investment in physical and social infrastructure while preserving our low external public debt distress risk rating and low domestic financing**. The tax reform measures, combined with the positive impact of the exchange rate depreciation on custom duties and other taxes, are expected to raise general government tax revenue to at least 11.3 percent of GDP. This somewhat cautious revenue forecast recognizes the uncertainties of the exact impact of the reform effort. In this light, we intend to use the bulk of any domestic revenues or external financial support over and above the budget projections to raise pro-poor expenditure and reduce domestic financing. Expenditure will be contained at about 19.8 percent of GDP with recurrent expenditure maintained at 9.1 percent

and capital expenditure rising to 10.8 percent. The overall deficit, excluding grants, is targeted at 6.5 percent of GDP. We also intend to further our efforts to enhance expenditure management.

Action	Timing
• Prepare for the introduction of Program Based Budgeting in 2011/12	2010/11
• Complete study to move to a standard single tax rate on investment income (excluding interest income).	The study is on progress and will be completed by November 2010.

Public sector

9. **We will continue to monitor closely the domestic borrowing of the public enterprises and agencies**. An inter agency committee is now monitoring enterprise borrowing on a monthly basis. The limit on the aggregate domestic financing of public enterprises and agencies will be set at 10 billion birr or 2.1 percent of GDP in 2010/11. We believe this target is consistent with overall credit and money growth that allows for sufficient credit expansion to the private sector and avoids a build-up of excess demand pressures on the economy. Domestic fuel prices have been adjusted monthly since October 2008 with prices set somewhat higher than import costs to enable the Oil Stabilization Fund to repay its accumulated debt to the banking system.

Monetary policy

10. **We have recently adopted reserve money as our nominal anchor**. The objective of monetary policy is to maintain inflation in the single digits and promote a remonetization of the economy to foster credit to the productive sectors, thereby stimulating growth and employment. To support these objectives, we aim to absorb the remaining excess liquidity in the banking system by end-2010 and will abolish the exceptional bank-by-bank credit ceilings as soon as possible thereafter, subject to confirmation that inflation remains in the single digits. We are committed to achieving positive real interest rates on deposits. We aim to contain reserve money growth in the single digits in 2010/11, aided by very low credit from the NBE to government. We are working to refine our liquidity management capability, including through a move to weekly T-bill auctions and introduction of 1 year T-bills. Broad money is projected to grow by 35–40 percent in 2010/11, on stronger deposit growth and credit demand from the private sector. We are also strengthening our oversight of the financial system. We will also modernize our reserve and liquidity requirements regulations by early 2011.

Action	Timing
• Introduce weekly treasury bill auctions	December 2010
• Modernize reserve and liquidity requirement regulations	March 2011
• Introduce a 1 year Treasury bill	December 2010

Exchange rate and external policy

11. **The government is committed to adjusting the nominal exchange rate in order to preserve external competitiveness and to continue to gradually rebuild official external reserves**. For 2010/11, a further rebuilding of net external reserves by US$210 million to 2.3 months of imports is targeted. Exchange rate adjustment on September 1, 2010, has brought Ethiopia's real effective exchange rate close to that consistent with external equilibrium. We have not introduced, nor will we introduce, any new, or intensify any existing, exchange restrictions.

12. **Avoiding an unsustainable accumulation of public external debt is a key objective of the government economic policy**. In September 2010, the government contracted for non-concessional external loans of US$296 million to finance hydropower infrastructure with a further US$700 million planned later in 2010/11 for infrastructure and productive investments. These borrowings are consistent with a cautious approach to non-concessional debt and maintaining our low risk external public debt rating. The government is committed to maintaining effective oversight over the evolution of public sector external debt, including that incurred by the public enterprises, and will update its debt management strategy. While the debt sustainability analysis provides a reassuring assessment of Ethiopia's low external debt distress risk, we will continue to keep debt levels under close review and we will make every effort to ensure that new borrowing is contracted on concessional terms and that large foreign-financed projects are subject to rigorous economic appraisals before being approved.

IV. Medium-Term Outlook

13. **Our new 5 year Growth and Transformation Plan has recently been finalized and submitted to parliament for approval**. It covers the period 2010/11−14/15 and has benefitted from broad consultations across all segments of the population as well as with development partners. The plan seeks to achieve at least an 11 percent real growth rate, aiming to enhance social development and achieve the MDGs. We aim to maintain inflation in the single digits, preserve macroeconomic stability, and ensure our public debt remains sustainable. Agriculture will continue to be the engine of growth and the main focus of efforts to improve productivity and rural income growth, but aim to have the industrial sector play a key role in economic development. Large public investments in transportation and energy infrastructure are planned. A high case scenario aims at 14.9 percent real growth. While these objectives are ambitious, we believe they are achievable with greater mobilization of domestic savings and donor financial support.

V. National Account Statistics

14. **We are committed to improving the quality of macroeconomic statistics, in particular the compilation methodologies and institutional arrangements for the national accounts**. We have adopted and are implementing an action plan to strengthen national accounts statistics. We will seek further technical assistance support from the IMF Statistics department and other relevant external statistical agencies to implement this plan.

VI. Safeguards and Reporting

15. **The 2001 safeguards assessment was updated in December 2009** and identified some issues relating to the oversight of the external and internal audit functions. In response, the NBE established a functional Audit Committee and set up an independent review of monetary data submitted for program monitoring purposes by the NBE's internal auditors.

16. **We continue to benefit from the policy and technical advice of IMF staff and wish to maintain close engagement**. To help ensure regular and close surveillance by IMF staff, we are committed to submitting economic and financial data to the Fund, as laid out in Table 3.

Table I.1. Ethiopia: Quantitative Performance Criteria and Benchmarks 1/
(In millions of birr, unless otherwise indicated)

	2009/10												2010/11
	September			December			March		July 7				September
	QB	Adjusted QB	Act.	PC	Adjusted PC	Act.	QB		PC		Adjusted PC	Act.	QB
							Prog.	Act.	Prog.	Rev. prog			
A. Quantitative performance criteria (PCs) and quantitative benchmarks (QBs)													
Net foreign assets of the National bank of Ethiopia (floor) 2/ (In millions of U.S. dollar)	-260	-228	-111	-350	-377	-111	-278	-13	-80	-80	-171	-35	-150
Net domestic assets of the National Bank of Ethiopia (ceiling) 3/	3,420	3,021	2,439	4,784	5,122	1,722	6,214	4,783	6,945	5,945	7,181	3,237	1,380
Net domestic financing of the general government (ceiling) 3/	2,496	2,097	-899	1,983	2,321	-4,340	2,895	-2,700	5,823	3,000	4,236	1,758	1,000
Net credit to public enterprises (ceiling)	1,806	1,806	1,060	3,338	3,338	1,805	5,258	2,940	6,270	6,570	6,570	4,422	2,100
New non-concessional external debt contracted or guaranteed by the public sector (ceiling) 4/ (In millions of U.S. dollar)	500	500	0	500	500	0	500	0	500	500	500	470	500
Outstanding external payments arrears (ceiling) 5/	0	0	0	0	0	0	0	0	0	0	0	0	0
B. Adjusters to quantitative performance criteria													
Disbursed non-project external assistance (In millions of U.S. dollar)	0	32	32	250	223	223	350	412	670	659	…	568	0
C. Quantitative benchmarks													
Reserve money (ceiling)	478	478	1,182	824	824	472	3,069	4,637	6,604	4,800	4,800	2,957	-649
Federal government revenue collection (floor)	8,774	8,774	9,716	20,105	20,105	22,606	29,840	31,090	39,711	44,000	44,000	44,029	10,900

1/ Cumulative flow from the start of Ethiopia's fiscal year (July 8).
2/ Adjusted upward/downward for 100 percent of any non-project external assistance that exceeds/falls short of programmed amounts, subject to specified caps.
3/ Adjusted upward/downward for 100 percent of any non-project external assistance that falls short of/exceeds programmed amounts, subject to specified caps.
4/ Excluding the Ethiopian Airlines.
5/ This shall be a continuous performance criterion.

Table I.2. Ethiopia: Structural Benchmarks

Measure	Date	Status
Ensuring close monitoring of public enterprises		
• The public enterprise monitoring committee to receive annual financing and investment plans from all key public enterprises (ETC, EEPCo, Housing Agencies, etc.).	September 2009	Met. The Committee has focused on enforcing domestic bank borrowing limits. Focus being extended to non-bank borrowing.
• Report progress in compliance with borrowing targets to the Minister of Finance and Economic Development on a monthly basis.	Continuous	Met.
Establishing a liquidity control framework		
• Establish a high level joint committee, comprised of NBE and MoFED staff, to exchange information on liquidity needs on a weekly basis.	September 15, 2009	Met.
• Develop a formal liquidity forecasting framework in manual form and prepare fortnightly forecasts of liquidity needs for use in setting auction volumes.	January 2010	Met. Manual produced and initial forecasts made.
• Implement liquidity control framework.	June 2010	Met.
Tax reforms		
• The Minister of Finance and Economic Development to approve a tax reform strategy with a time-bound action plan covering both tax policies and administration.	January 2010	Met. Strategy approved February 2010 with action plan being implemented.
• Transfer the collection of some taxes from Addis Ababa City to ERCA.	September 2010	Completed.
National Accounts Statistics		
• Adopt action plan to strengthen national accounts statistics.	August 2010	Completed.

Table I.3. Ethiopia: Data Reporting

Information	**Provider**	**Periodicity and due date**
Gross international reserves and foreign liabilities of the National Bank of Ethiopia (NBE) Breakdown between liquid and unencumbered reserves and reserves that are pledged, swapped or encumbered	NBE	Monthly within thirty days of the end of each month
Net domestic assets of the NBE	NBE	Monthly within six weeks of the end of each month
Reserve Money	NBE	Monthly within six weeks of the end of each month
Net domestic financing of the general government Regional government's fiscal data	Ministry of Finance and Economic Development (MOFED)	Monthly within six weeks of the end of each month Quarterly within twelve weeks of the end of each month
Domestic credit to public enterprises	NBE/MOFED	Monthly within six weeks of the end of each month
Federal Government Revenue	MOFED	Monthly within six weeks of the end of each month
New Nonconcessional External Debt contracted or guaranteed by the government	MOFED	Quarterly within four weeks
Non-project financial assistance	MOFED/NBE	Quarterly within thirty days
Consumer Price Index	NBE	Monthly within four weeks
National Accounts	MOFED	Within three weeks of any revision
Consolidated Budget Report of Federal and Regional Government	MOFED	Quarterly within twelve weeks
Monetary Survey	NBE	Monthly within six weeks
T-Bill auction details	NBE	Monthly within two weeks
BoP data: Exports, imports, services, private transfers and capital account transactions	NBE	Quarterly within eight weeks
Volume and prices of fuel imports	NBE	Monthly within four weeks
Coffee exports	NBE	Monthly within four weeks