ETHIOPIA

DISRUPTED MOMENTUM

Ethiopia is expected to report its lowest growth rate since 2003. Although the population has been relatively spared by the brunt of the Covid-19 pandemic, the cyclical economic environment has deteriorated sharply. The country has been hard hit by both a domestic shock and a decline in external revenues, which is squeezing its structurally low foreign reserves. Support from multilateral creditors will limit liquidity risk in the short term, but the current situation largely underscores the need for reforms. At the same time, political risk is rising with the emergence of socio-political tensions that pose significant challenges for Ethiopia's political and economic stability.

ECONOMIC MOMENTUM IS CUT SHORT

The Covid-19 crisis interrupted Ethiopia's growth momentum, which had averaged about 10% a year over the period 2004-2019. Driven by large-scale, debt-financed public investments, the country's growth model had already reached its limits and contributed to major imbalances. The current shock highlights these vulnerabilities and the need to accelerate reforms that aim to increase its reliance on foreign direct investment (FDI) through economic liberalisation. Although growth is expected to remain positive in 2020, it will sink to the lowest level ever witnessed since 2003.

The economic crisis is manifest in both the domestic and external shocks. Agriculture, which accounts for 80% of export revenues and nearly 40% of GDP, was especially hard hit by the sharp decline in harvests due to a massive locust invasion, military conflicts in the northern region and declining demand. The drop-off in external demand and the disruption of global supply chains also had major repercussions on exports of services.

At the same time, annual inflation soared to 20% in 2020. Fiscal and monetary measures to stimulate the economy helped drive up prices, but these measures are expected to wind down in the months ahead. In 2021, the economy is expected to continue slowing, with the latest forecasts calling for zero growth. Price inflation is expected to ease, but will remain high, with 2021 inflation estimated at 11.5%. The central bank should continue to make massive injections into the economy by participating in the financing of the public deficit.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	9.0	1.9	0.0	8.9
Inflation (CPI, year average, %)	15.8	20.2	11.5	8.0
Central gov. balance / GDP (%)	-2.5	-3.5	-3.1	-1.1
Central gov. debt / GDP (%)	56.9	56.6	55.8	56.9
Current account balance / GDP (%)	-5.1	-5.2	-4.6	-3.4
External debt / GDP (%)	31.1	32.2	34.4	35.8
Forex reserves (USD bn)	3.4	3.1	4.7	6.8
Forex reserves, in months of imports	2.4	2.1	2.7	3.3
Exchange rate USDETB (year end)	32.0	33.9	35.1	37.0

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

UNPRECEDENTED ECONOMIC SLOWDOWN AND RISING INFLATION

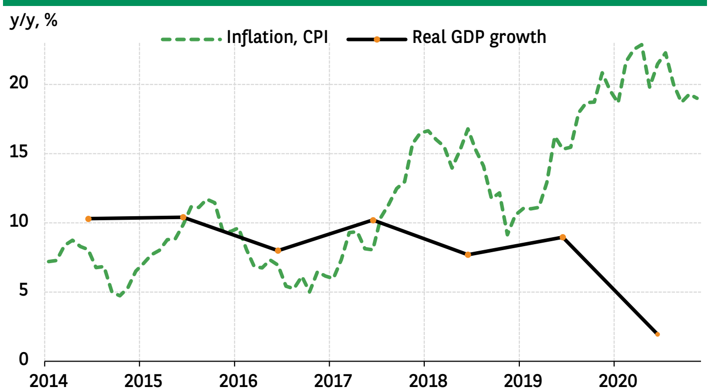

CHART 1 SOURCE: IMF, CENTRAL STATISTICAL AGENCY OF ETHIOPIA, BNP PARIBAS

RESURGENCE OF POLITICAL AND MILITARY CONFLICTS

The downturn in economic prospects has been accompanied by a major deterioration in the political environment. The re-emergence of ethnic conflicts is a clear reminder of the country's fragile political situation. With the adoption of a new constitution in 2010 and the peace treaty signed with Eritrea in December 2018, the social-political environment entered a period of stabilisation. Abiy Ahmed's arrival as prime minister in April 2018 also made it possible to make some progress in terms of governance.

The social-political environment has deteriorated in recent months, however, due to growing discontent with the government. The arrest of prominent opposition leaders, the introduction of a law forbidding opposition members from serving as public officials, and heightened executive powers in the midst of a state of emergency sparked fierce criticisms. This frustration was expressed in popular protests and uprisings as well as in tensions within the government, and was only exacerbated by economic hardships, health restrictions and the postponement of general elections.

Tensions crystallised with the postponement of the general election, originally scheduled for August, and the extension of electoral terms. The deterioration in the political situation in the Tigre region in the northern part of the country is particularly concerning. The local authorities (Tigray People's Liberation Front, TPLF) decided to defy the postponement of the general election by holding elections in September. This move exacerbated the hostilities between the regional and federal authorities, resulting in the deployment of the military and armed conflict. These clashes risk sparking conflicts throughout the country as ethnic demands emerge in other regions. The conflicts will not only have local consequences, but could have regional repercussions as well, since Ethiopia plays a major role in the region's security.

These tensions also add to the diplomatic disaccord with Sudan and Egypt concerning the finalisation of the Grand Ethiopian Renaissance Dam (GERD). Egypt and Sudan accuse Addis-Ababa of threatening their water supply, which is already irregular due to adverse weather conditions. Negotiations are still pending concerning the filling of the dam, which is likely to push back the project's completion, scheduled for 2023.

These factors are currently eroding any optimism about progress towards a real economic transition. The current environment is likely to hamper key reforms. Further tensions also risk delaying certain investments and privatisation projects by scaring off non-resident investors.

EXTERNAL FINANCES COME UNDER GREATER PRESSURE

The postponement of foreign investment would be particularly harmful for the Ethiopian economy. The country suffers from a structural shortage of foreign currency, which is its main source of vulnerability. Its weak and volatile export base is largely handicapped by an overvalued exchange rate, and has been accompanied by growing import demand in recent years. This has reduced the amount of foreign currency revenues and increased liquidity risk.

Current levels are too low for the authorities to make adjustments to counter the shock. With the crisis, the current account deficit is expected to hold at about 5% of GDP. Despite the decline in imports of goods and services and improvements in the terms of trade (thanks notably to lower oil prices), exports are expected to cover only 18% of imports in 2020. Exports of services are expected to contract sharply (down an estimated 24% in 2020) given the sharp decline in tourism revenues, its main component.

The capital account is also expected to deteriorate in 2020 due to risk aversion and the lack of non-resident capital inflows. Net FDI has declined and covered only 40% of the current account deficit in 2020 (vs an average of more than 60% in 2015-2019).

The external financing need is estimated at USD 6.2 billion in 2020. The Debt Service Suspension Initiative (DSSI) is not included in this figure and will partially reduce this amount as well as next year's financial requirements. Still, foreign reserves are also very low, estimated at 2 months of imports. This leaves the authorities with very little manoeuvring room to deal with a massive liquidity shortage.

Despite efforts launched to develop the export base in the short term, imports are expected to increase more rapidly than exports and to widen the trade deficit.

The total stock of external debt is estimated at 30% of GDP in 2020 (60% of which is held by the central government). Although the level is still limited, the cost should continue to rise. The external debt servicing charge could swell to a third of exports, which would signal a state of alert. The currency's fixed exchange rate limits any adjustments to counter the shock.

Persistent current account deficits, low foreign reserves and the increase in external debt repayments therefore fuel external solvency risks.

SHALLOW LIQUIDITY DUE TO THE FOREX REGIME

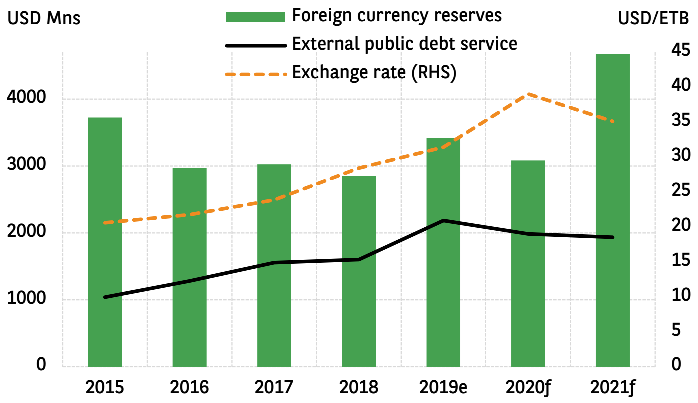

CHART 2 SOURCE: NATIONAL BANK OF ETHIOPIA, IMF, BNP PARIBAS

Fortunately, debt-restructuring agreements recently signed with China and the Debt Service Suspension Initiative (DSSI) with the Paris Club of creditors will help alleviate financial pressures in the short term. Emergency liquidity lines provided by the IMF and the World Bank are also a non-negligible source of funding. Yet given the large share of debt held by unofficial creditors and bondholders, sovereign risk in foreign currency is still very high: external debt accounts for more than half of total public debt (59%) and external debt servicing accounted for nearly 65% of foreign reserves in 2020. External public debt payments should increase in the years ahead with the refinancing of the USD 1 billion Eurobond maturing in 2024.

The IMF programme concluded in late 2019 is the key to shoring up the country's solvency and launching the structural reforms necessary to ensure the economy's attractiveness and debt sustainability. Adjusting the exchange rate is still one of the key short-term measures. Yet this reform would imply a short-term deterioration in the trade deficit, greater risk of inflation and a heavier debt burden. Although the country has some financial support, it is still walking on a tight rope.

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