Ethiopia

Strategy change

In order to support economic growth, the Ethiopian government is transitioning from the traditional debt investment strategy to a foreign equity-based one, by privatizing some state-owned entities and removing foreign investments' barriers. The recently approved IMF program is targeted to address foreign-exchange shortages as well as to contain debt vulnerabilities by strengthening state-owned enterprises management. Nevertheless, the moving towards a more liberalized exchange rate will be done gradually to avoid triggering inflationary pressures and consequent social unrests.

Ethiopia has experienced a public investment-driven strong growth model for the last 15 years. This model has definitively reached its limits and has now resulted in high vulnerabilities, principally forex shortage and increasing external debt and servicing costs. To tackle them, the authorities have designed a new economic program (the Homegrown Economic Reform Plan) and obtained the IMF financial support. This might speed up the long-awaited transition towards a more flexible exchange rate regime. But in a context of high inflation and given that general elections are approaching, this is likely to be cautiously implemented.

Economic growth weakening and inflationary pressures

After a period of double-digit growth between 2004 and 2017, the economy has been experiencing a slowdown since 2018 because of a steady deterioration in the terms of trade. Indeed, dipping coffee prices (around 40% of total exports) and rising oil prices (+31% in 2018 for the Brent) have strongly weighted on external accounts so far. Due to external account weakness, foreign exchange restrictions hamper economic growth and contribute to flagging industrial growth. Nevertheless, economic growth remains robust, supported by solid private consumption, fostered by strong demographic growth[1] as well as gradual poverty reduction[2].

Investment is another engine of the economic activity. Important public infrastructure investments are in progress, while foreign direct investments (FDI) remain sustained. They are currently above 4% of GDP and are mainly focused on manufacturing industries. The energy sector concentrates the bulk of national investment efforts. In a country where only 30% of population have access to electricity, needs are huge. Several power supply projects have been launched since 2018 for an amount of USD 6 bn. Moreover, a USD 1.8 bn agreement has been reached with a Chinese public company to complete the electricity distribution network.

Consumer price inflation has reached 20% at November – its five-year higher point – reflecting food shortages, owing to lower agricultural output in the harvest season. On average, it should remain above 10% in 2020.

Looking for stronger private sector participation

The authorities have settled their economic policy over two main axes: i) stimulate private-sector contribution thanks to their new economic program, and ii) reduce macroeconomic imbalances through the IMF support.

Opening the economy to foreign investors is a priority. Parliament is finalizing the new investment law enabling foreign companies to enter joint ventures with Ethiopian companies, up to a maximum 49% share of ownership. Sectors involved are aviation, energy, logistics and telecommunications.

At the end of November, the government announced that it will remove barriers to investment in the mining sector and that it will privatize six sugar projects in Q1 2020. Industry should also benefit

[1] It has averaged +1.6% per year over the past 10 years.
[2] GDP per capita has tripled in 10 years, and stood at USD 950 in 2019.

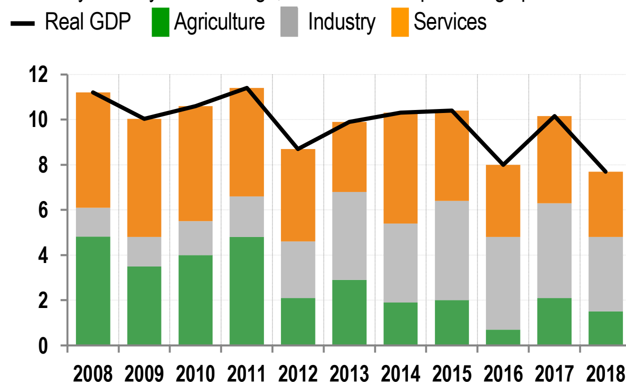
1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	7.7	7.4	7.2	7.1
Inflation (CPI, year average, %)	13.8	14.6	12.7	9.3
Central gov. balance / GDP (%)	-3.2	-2.8	-3.0	-3.0
Central gov. debt / GDP (%)	61.0	59.1	54.4	52.2
Current account balance / GDP (%)	-6.5	-6.0	-5.3	-4.7
External debt / GDP (%)	35.8	34.5	33.6	32.2
Forex reserves (USD bn)	4.0	3.9	4.3	4.5
Forex reserves, in months of imports	2.0	2.8	3.2	3.4
Exchange rate USDETB (year end)	28.4	31.4	33.5	35.1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth and contributions by sector

GDP in year-on-year % change, contributions in percentage points



Source: IMF

from an improving power supply and some fiscal incentives, including the elimination of import duty on capital goods, income tax exemption for companies operating or developing industrial parks and export tax exemptions.

In the financial sector, the rule forcing banks to divert 27% of their loan book to the public sector has also been lifted.

On December 20th, the IMF Board approved a three-year USD 3 billion financing package (around 3% of GDP), with an immediate disbursement of USD 308 million. The program aims to address foreign exchange shortages, reform state-owned enterprises and strengthen fiscal revenue (currently at 10% of GDP only).

Regarding public finances, the fiscal deficit strongly increased after 2016. It averaged 2.8% of GDP between 2016 and 2018. It is expected to decrease slightly in 2019 thanks to a more conservative current spending policy while capital expenditure should be limited to already committed projects. This should allow the debt-to-GDP ratio to decline (it was around 61% of GDP in 2018). Debt ratios will also benefit from the privatization of some state-owned enterprises.

Easing pressure on foreign exchange liquidity

If fiscal deficits seem to be under control, external accounts remain a major weakness of the Ethiopian economy. The large trade deficit (-14% of GDP) contributes to large deficits in the current account balance despite the positive contribution of transfers from private funds and public donors. In net value, these total transfers represent 55% of total current account receipts. The current account deficit reached an average of 8.6% of GDP between 2014 and 2018.

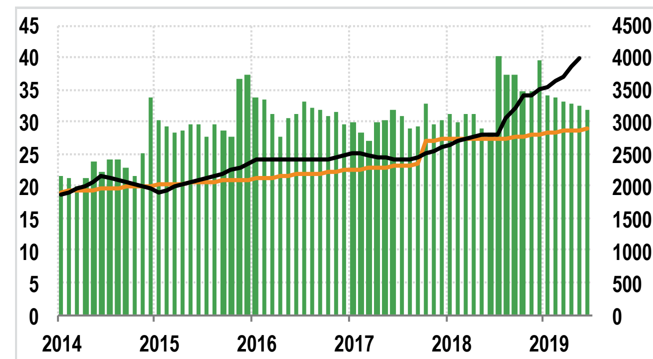
Even though the country continues to attract the largest share of FDI in East Africa, net FDI has recently moderated and covers about 70% of the current account deficit. The rest is financed through external debt, mostly on concessional terms. Foreign exchange reserves are also partly channeled to service external debt (around 8% of total foreign-exchange earnings in 2018).

The central bank's purpose is to maintain currency depreciation under control. It thus draws on its foreign reserves to contain exchange rate fluctuations. The Birr depreciated by around 10% against the USD in 2019. However, central bank's resources are limited as foreign exchange reserves are below the warning level of three months of g&s imports. At end-2019, forex reserves were around USD 3.6 bn, covering only 2.2 months of g&s imports. As a result, capital controls are also in place, which strongly constrain imports. Pressures on the Birr thus remain considerable, and the gap between official and black markets is around 40%.

The IMF agreement might help to catalyze concessional financing from other development partners. An additional World Bank support package by USD 3 billion is being considered, which would support the country's reforms substantially.

To foster foreign-currency inflows, the government has also decided to mobilize the Ethiopian diaspora, estimated at around 3 billion people. To support their investment into several economic sectors, a government fund was created in October 2018, the Ethiopian

3- Exchange rate and forex reserves



Source: IMF, BNP Paribas

Diaspora Trust Fund, in charge of raising their funds. In September, the central bank relaxed exchange control regulations on foreign-currency accounts held by the diaspora to simplify their transfers to the country. For the moment, the amount raised is quite symbolic (about USD 5.4 million in 2019).

We therefore note that the macroeconomic situation is still weak, but international financial support might ease tensions on fx liquidity, at least temporarily. In 2020, central bank's foreign exchange reserves should reach USD 4.3 bn, covering 3.2 months of imports. This positive trend should keep on in 2021. Nevertheless, external accounts will remain vulnerable to commodity price volatility and high import needs.

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