



KEY CHALLENGES (CONT'D...)

- With pro-cyclical (i.e. expansionary) fiscal policy, still significant structural constraints in the economy, and rapid expansion of monetary aggregates (broad money up 23% per year, on average, since '02) it is not surprising to see resurgent inflation (39% y/y for May). Hence, unlike in many countries where (imported) food and energy prices are the legitimate culprits for higher inflation, domestic macro-policy is just as much to blame in Ethiopia;
- Whereas at first, rising agricultural goods prices were seen as a means to increase farmers' incomes, the authorities are quickly becoming aware of the macro (not to mention social) dangers of rampant "agflation" (food component up 54% y/y in May);
- We found that the NBE lacks a robust framework to effectuate monetary policy: corrective measure have ranged from the orthodox (e.g. tighter fiscal policy (at last), a cap on base money growth, etc.) to the less orthodox or downright misguided (e.g. expanding food subsidies, form consumer cooperatives, and crackdowns on "price gougers");
- The challenge for this government, and continued macro-stability, will be balancing demand-dampening measures with long term growth-enhancing (and poverty reducing) ones. Again, we remain hopeful that the government will recognize the key role that the private sector and FDI stand to play here;
- The higher energy import bill (now over 20% of total imports) coupled with an already elevated need to bring in capital goods (35% of total imports) have eroded foreign exchange reserves considerably –these are now at a crippling six weeks' worth of imports (or less) leading to some disruptive FX rationing measures in the economy;
- We do feel this balance of payments problem is rather transient in nature. Near term, the government should seek to boost external (concessional) financing, minimizing the crowding out of domestic resources, and generating some FX reserves in the process. Sustaining this over the medium term does hinge on constructive relations with the international donor community (read: minimize unilateralist adventures in Eastern Africa);
- Longer term, we are more optimistic. As already stated, much of the FX requirement is driven by capital goods imports related to large infrastructure projects which, typically, are self-financing as foreign partners provide the funding. Moreover, in some of these projects, namely in hydroelectricity generation, Ethiopia stands to become a significant exporter and therefore gain access to a steadier stream of hard currency revenues;
- Finally, though Ethiopia benefits from membership in a number of regional and bi-lateral trade regimes, WTO membership is still a ways off.

ON THE POLITICAL FRONT...

- Power effectively rests with the Prime Minister, Meles Zenawi, who has been in that post since 1995. By most accounts he is extremely hands on...perhaps so much so that succession risk may become a non-trivial issue at some point;
- Great efforts at decentralization have allowed wider participation in decision making by the regions and progress on this front will remain central to limiting ethnic political risk;
- Some speakers we met with lamented about a marked "narrowing of the political space"...citing the many technical and administrative roadblocks opposition parties faced in recent local elections as well as some new government measures designed to limit the influence of foreign NGOs;
- We concur there is indeed some heavy-handedness on the part of the government, for which evidence ranges from closing off key sectors to foreign investment entirely (i.e. banking, telecom, retail, among others) to little things like text messaging not working and a peculiar sign in the hotel's business center "Skype and other VoIP Services are illegal in Ethiopia." In all fairness, the latter isn't permitted in the UAE either, so what ultimately matters is the direction in which reforms are headed. Though early, and not without its own set of risks, we believe Ethiopia is turning in the right direction. ■