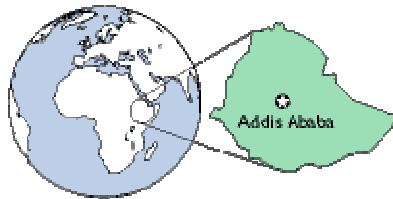


COUNTRY REVIEW

Ethiopia



21 August 2009

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EULER HERMES COUNTRY RISK GRADE: D

**Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.**

Strengths

- Political continuity is likely in the ST, even after elections in 2010
- Solid GDP growth in recent years, with an annual average 7.8% in 2001-08
- The international community is generally supportive, particularly through times of famine

Weaknesses

- Governments have a reputation for abrogation of political liberties and international agencies question the commitment to protection of human rights and limitation of corruption
- The region (Horn of Africa) is high risk, with borders with Sudan, Eritrea and Somalia all offering challenges
- High dependence on rain-fed agricultural output but recurrent drought and locust infestations
- Continuing aid dependence, despite significant foreign debt forgiveness,
- Weak foreign exchange reserves provide only around one month of import cover
- Weak structural business environment

Key Risks

- **Sovereignty and security issues are high risk. Several areas within the country seek secession and porous borders with Somalia and Eritrea provide conduits for terrorist incursions, as well as potential for cross-border military activity**

Country Risk Assessment

Ratings	Mauritania		Median Grade D	Peers		
	Latest	Previous		Mauritania	Nigeria	Cameroon
Systemic Political Risk:	P4	P4	P3-	P4	P3-	P3-
Systemic Economic Risk:	E6	E6	E6	E6	E6	E5
ME rating:	ME6	ME6	ME6	ME6	ME4	ME4
<i>Structure</i>	6.0	-	6.0	6.0	6.0	6.0
<i>Policy</i>	5.6	-	5.6	6.0	6.0	4.3
<i>Solvency</i>	3.3	-	4.3	6.0	1.9	2.0
<i>External Liquidity</i>	6.0	-	4.6	6.0	1.9	2.8
SBE rating:	SBE5	SBE5	SBE5	SBE5	SBE6	SBE5
COUNTRY GRADE:	D	D	D	D	D	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Addia Ababa
Population:	78.65 mn (2007)
GDP:	USD 17182 mn (2007)
Currency:	Birr (ETB)
Form of state:	Republic
Head of government:	PM Meles Zenawi
Next elections:	Parliamentary by May 2010

Major Industries (% of GDP at market prices, 2008e)		Global Assumptions	2008	2009f
Agriculture	45.0%	Real GDP grth (% yr/yr) *	0.7	-3.0
Industry	13.0%	Inflation (% , av) *	3.4	1.0
Services	42.0%	Dated Brent (USD/b)	98.0	55.0
* major economies				

Main Exports (% of total, 2008e)		Main Imports (% of total, 2008e)	
Coffee	22.0%	Capital goods	22.0%
Oilseeds	16.0%	Fuel	9.0%
Leather & related goods	5.0%	Foodstuffs	3.0%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
Germany	8.2%	Saudi Arabia	17.0%
Saudi Arabia	7.0%	China	15.9%
US	6.9%	India	7.8%
China	6.5%	Italy	5.1%

Basic indicators

Selected economic indicators	2005	2006	2007	2008	2009f
Nominal GDP (USD mn)	11,078	13,649	17,183	25,149	26,087
Population (mn)	74.66	76.63	78.65	80.71	82.08
GDP per capita (USD)	148	178	218	312	318
Real GDP growth (% yr/yr)	12.6	11.5	11.5	11.6	5.0
Inflation (% , average)	11.6	12.3	17.3	44.3	18.0
Fiscal balance (% of GDP)	-4.9	-4.3	-4.1	-3.2	-2.4
Current account balance (% of GDP)	-14.2	-13.1	-4.8	-7.2	-9.2
External debt/GDP (%)	56.5	16.7	15.3	12.7	15.3
External debt/Exports of goods & services (%)	184.2	64.2	42.9	40.6	53.3
Debt-service ratio (%)	2.6	4.6	2.1	1.4	1.7
Foreign exchange reserves (USD mn)	1,111	822	1,278	859	1,000
Import cover (months)	2.7	1.8	2.2	1.1	1.3
Exchange rate assumption, ETB:USD (av)	8.67	8.70	8.97	9.60	11.50
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

The government of Prime Minister Meles Zenawi and the ruling Ethiopian People's Revolutionary Democratic Front (EPRDF) have countered strong domestic political opposition by **tightening internal security**. This has involved curbing press freedom and there are allegations of serious abuses of human rights. Donor countries and international aid agencies remain broadly supportive but are increasingly critical of the government's apparent undemocratic behaviour, its **intolerance of dissent**, including arrest and persecution of opposition leaders, and its propensity to close down independent media and suspend the activities of some aid projects.

In addition to formal political opposition and potential challenges to authority from within the military, there are significant **regional, tribal and ethnic divisions**. In two of the largest provinces, Oromia (accounting for one-third of the population) and Ogaden, there are rebel and secessionist groups, which perpetrate periodic attacks on infrastructure and acts of violence against tourists and foreign workers. Chinese employees engaged in the oil exploration industry in the east have been particular targets of the Ogaden national Liberation Front, which seeks independence from Addis Ababa.

Zenawi, who has been prime minister since 1991, announced this year that he will step down from that position before the **next elections in 2010**. However, he is relatively young (54 years) and believed to be in good health, so the announcement may have been made to gain political and diplomatic advantage (by signalling some democratic credentials) rather than signifying actual intent. In any event, the **EPRDF is likely to maintain its tight grip on the key levers of power, and policy formulation is unlikely to change course**.

Despite its Marxist-Leninist roots, the EPRDF under Zenawi has largely turned to the west and to the international donor community for support. More recently, with western donors prone to political judgements and more restrictive in lending, Ethiopia has been a beneficiary of China's strategic interest in developing links with raw material producers in Africa.

In addition to domestic political opposition and to the several separatist movements, Ethiopia has border concerns. As well as Kenya to the south and Djibouti to the north-east, Ethiopia has contiguous borders with Sudan, Eritrea and Somalia, countries with potential for involving Ethiopia in conflicts and/or exporting to it terrorist activity. Full-scale conflict with neighbouring Eritrea ended in 2000 but since then the **peace has been fragile and interspersed with border violations and other acts of aggression**, despite the presence of UN peacekeeping forces. Since Eritrea gained independence in 1993, **Ethiopia has depended on Djibouti for access to seaports** and thereby to trade links via waterborne transport. Relations with Somalia are similarly strained, with Ethiopian troops invading that country in 2007 in order to attempt to quash Islamist forces fighting the domestic military. The Ethiopian army formally withdrew from Somalia in early 2009, partly in recognition that it could not enforce peace in that country. **The region remains tense and volatile**.

Economic Stability

The second most populous African country (after Nigeria), Ethiopia is classified as 'low income'. It is also **one of the world's poorest economies**, with around 50% of the 80mn population engaged in subsistence farming and per capita GDP, although increasing, of only USD300 in 2008. **Periodic famines** remain a severe constraint on per capita GDP growth. The formal agricultural sector accounts for 45% of GDP, more than 80% of export earnings and employs an estimated 80% of the labour force.

Annual real GDP growth averaged only 2.9% in 1991-2000 but 7.8% in 2001-08 (with 11.4% in 2004-08). Relatively rapid growth in the latter period reflected a buoyant world economy, inflows of donor aid and investment (particularly from the Gulf States and Asia, including China) and Ethiopia's focus on agricultural-led industrialisation (including expansion of horticultural output) and development of the service sector. **We forecast that GDP growth will slow substantially in 2009, to around 5% from 11.6% in 2008**, supported by good rainfall early in the year but limited by the global economic recession, which has weakened commodity demand and reduced workers' remittances. With the global recovery currently forecast to be muted, Ethiopian **GDP growth will remain around 5-7% in 2010**. Downside risks to the growth outlook remain rain-fed agricultural output (recent rains have been average-to-weak) and the prospect that locust swarms may also limit harvests.

In July 2009, the official budget outlined a projection for a fiscal deficit of 1.5% of GDP for 2009/10, a figure similar to the outcome for 2008/09, as tabled in the latest budget statement. However, given the much weaker global environment from Q3 2008, **we estimate that fiscal deficits are around 2-4% of**

GDP, particularly given expenditure allocations on infrastructure and downward revisions to aid budgets in donor countries.

Inflationary pressures are a structural weakness of the economy and consumer price growth averaged over 44% in 2008, reflecting sharp increases in food and fuel prices. With the advent of the global recession and weaker commodity prices, combined with some monetary and fiscal policy initiatives, inflationary pressures have declined in 2009. However, we still **forecast average inflation of around 18% in 2009, perhaps declining to 15% in 2010.**

Another structural weakness is the current-account deficit, which can range from 5% to 15% of GDP and financing of which requires international assistance. Partly as a result of the weak external sector, including competitiveness pressures on the birr, FX reserves are low. At USD859mn at end-2008, reserves provided **only 1.1 months of import cover**, compared with an internationally-acknowledged "safe" minimum of three months. FX reserves and import cover will remain limited through 2009-10.

Ethiopia does not have an IMF financial facility in place but **follows a Fund-style policy programme in order to maintain support from the wider donor community.** Ethiopia completed its programme under the HIPC initiative in April 2004 thereby signifying an effective exit from the debt relief process and allowing the country to access an approximate USD300mn in additional annual concessional financing. The IMF and World Bank **granted full debt relief of USD1.3bn**, as well as USD707mn in 'topping up' in order to meet its (then) target of foreign debt/exports of 174%. Having exited the HIPC process the challenge for the government is to maintain its relatively lower level of indebtedness. Given the economy's fragility and the track record of weak management there is a risk of failure in this regard going forward, particularly if external developments (including international coffee prices and exchange rate movements) work against the country. In any event, Ethiopia will **remain highly aid-dependent.**

Structural Business Environment

The **business environment is weak.** The Heritage Foundation 2009 Index of Economic Freedom (IEF) categorises Ethiopia as "Mostly Unfree" and ranks it 135 out of 179 countries assessed, above Cameroon, Ecuador and Argentina but below Indonesia, China and Nepal. Under the IEF methodology, Ethiopia does not record high levels of economic freedom in any category, although the tax burden is relatively low and flexibility in the labour market equates to the world average. Protection of property rights (**private ownership of land is not allowed**) remains weak and corruption is perceived as a significant deterrent to business. Moreover, the legal system is unreliable, corporate data transparency is weak and bureaucracy is inefficient. In the World Bank's Doing Business 2009 survey, Ethiopia ranks 116 out of 181 economies assessed, with bankruptcy resolution taking less time and involving less cost than the regional average and the recovery rate is almost double the average. In relation to enforcement of contracts, the cost in Ethiopia is significantly less than the regional average but it takes longer to achieve settlement. Ethiopia ranks 126= with Eritrea, Indonesia, Libya and Uganda out of 180 in Transparency International's 2008 Corruption Perceptions Index (above Nicaragua, Pakistan and Ukraine but below Nigeria, Togo and Vietnam). **Infrastructure is generally weak** and is a major impediment to commercial transactions outside the main urban centres, and thereby to stronger overall economic growth. Basic development indicators also suggest limitations to sustainable economic growth.

The financial sector is relatively small for a country with a population of over 80mn and **foreign banks are proscribed from participation.** The government maintains a strong influence over lending and control of interest rates and it owns the largest commercial bank, which accounts for around two-thirds of outstanding credit. Over exposure of lending to inefficient state-owned enterprises almost led to collapse of the largest state-run bank. Nevertheless, NPLs have reportedly been reduced from over 50% of the loan book to a current 10%. The absence of a large and efficient credit market is a hindrance to a more vibrant rate of economic growth, particularly in relation to the contribution from rural areas. However, the latter are becoming increasingly served by a micro-finance sub-sector.

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Charts

