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Staff Country Reports

The Federal Democratic Republic of Ethiopia: Joint Staff Assessment of the Poverty Reduction Strategy Paper Annual Progress Report

The attached Joint Staff Assessment (JSA) of the Poverty Reduction Strategy Paper Annual Progress Report for The Federal Democratic Republic of Ethiopia, prepared by the staffs of both the World Bank and IMF, was submitted with the member country's Poverty Reduction Strategy Paper (PRSP) or Interim PRSP (IPRSP) to the Executive Boards of the two institutions. A JSA evaluates the strengths and weaknesses of a country's poverty reduction objectives and strategies, and considers whether the PRSP or IPRSP provides a sound basis for concessional assistance from the Bank and Fund, as well as for debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Debt Initiative. The Boards then decide whether the poverty reduction strategy merits such support.

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ETHIOPIA

**Poverty Reduction Strategy Paper Annual Progress Report
Joint Staff Assessment**

Prepared by the Staffs of the IMF and IDA

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I. OVERVIEW

1. **Ethiopia's Poverty Reduction Strategy Paper (PRSP), the Sustainable Development and Poverty Reduction Program (SDPRP) was approved by the Government in July 2002.**¹ It covers the period 2002/03 to 2004/05.² The Joint Staff Assessment (JSA) of the SDPRP concluded that the policies contained in the SDPRP should result in substantial progress in Ethiopia's fight against poverty.³ The SDPRP was reviewed by the Executive Boards of the IMF and World Bank in September 2002.

2. **The government of Ethiopia has prepared the first Annual Progress Report (APR) for the SDPRP, and submitted it to the Fund and World Bank on December 5, 2003.** On December 23, 2003, the authorities submitted a revised Chapter VI for inclusion in the APR. The APR outlines progress in implementing Ethiopia's poverty reduction strategy during 2002/03, and presents an updated policy matrix that refines the three-year program and results framework. This period saw the worst drought since 1984, requiring food aid for about 13 million people compared with about 5 million people in a normal crop year, while real GDP declined by almost 4 percent. This inevitably affected the pace of progress during the review period. Nevertheless, in the view of the staffs, the government has made a strong effort at SDPRP implementation, and the APR largely reflects that progress. The PRSP

¹ www.imf.org: Ethiopia—Sustainable Development and Poverty Reduction Program, July 31, 2002.

² July 7 to July 8.

³ www.imf.org: Ethiopia—Joint Staff Assessment of the Poverty Reduction Strategy Paper, August 27, 2002.

process has taken root in Ethiopia quite significantly in the past year – the SDPRP is increasingly seen by government as the organizing framework for policy and programs, and by donors as the basis around which to mobilize and harmonize support. Reflecting the government's view that a major reexamination of SDPRP goals and strategy after only one year is premature, and recognizing capacity constraints, the APR focuses largely on implementation issues, and consolidating policies in light of lessons learned.

3. **Progress in addressing weaknesses identified in the Joint Staff Assessment (JSA) of the original SDPRP has been mixed.** Alternative macroeconomic scenarios have been developed in order to reflect the vulnerability of growth to exogenous shocks, and strategies in food security and agriculture have been articulated; there has been substantial progress with decentralization; and plans to strengthen the monitoring and evaluation system have been developed. However, analysis of the links between sectoral policies, growth and poverty proved more difficult than anticipated, although preliminary poverty and social impact analysis was undertaken of the VAT and coffee price declines. Progress has been less evident in developing the agenda for private sector development, and in addressing the disconnect between program costs and budgets, and these provide important items for the agenda of the second year of implementation.

4. **Preparation of the APR benefited from consultations with a range of non-government institutions.** The draft was circulated to civil society organizations and the donor community, and workshops were held to elicit their feedback. The APR was also extensively discussed during the meeting of the Partnership for a New Coalition for Food Security for Ethiopia which was held on December 1-2, 2003. However, while there was a wide-ranging set of consultations in drafting the original PRSP, the participatory process has been slower to take root during implementation, due in part to capacity constraints in both the government and Non Government Organizations (NGOs). While civil organizations have been involved in formal consultations over development of a number of sector-specific policies in the past year, increasing non-government and local government involvement in SDPRP implementation and monitoring remains a challenge.

II. PROGRESS WITH POVERTY REDUCTION POLICIES AND PROGRAMS

A. Macroeconomic Policies

5. **Consistent with Ethiopia's three-year Poverty Reduction and Growth Facility (PRGF arrangement with the IMF), and despite the impact of the drought, the government continued the implementation of sound macroeconomic policies during 2002/03.** Monetary policy remained geared towards maintaining macroeconomic stability, supported by a prudent fiscal policy. Despite the economic contraction, the government continued to focus on enhancing revenue mobilization and prudent public expenditure management, and reallocation of public resources to poverty-reducing expenditure.

6. **The original SDPRP targeted annual growth in real GDP of 7 percent over the medium term (2002/03-2004/05), and the maintenance of price stability.** Largely because of the drought, neither of these objectives were met in 2002/03. Agricultural output declined by 12.2 percent, causing real GDP to decline by 3.8 percent. Pushed by substantial increases in cereal prices, average annual inflation rose from -7.2 percent in 2001/02 to 15.1 percent in 2002/03.⁴ The external current account deficit (including official transfers) declined from 5.7 percent of GDP in 2001/02 to 4.7 percent in 2002/03 (excluding official transfers, the deficit remained at 12.9 percent). For 2003/04 the government is projecting real GDP growth of 6.7 percent, spurred by a gradual agricultural recovery following a two-year decline caused by the prolonged drought, while inflation is projected to decline to an average of 5.5 percent as food supply conditions return to a more normal level.

7. **The progress report explains the difficulties encountered during 2002/03 in budget execution due to the severe impact of the drought.** With revenue falling short of projections, the government made every effort to contain expenditure while increasing poverty-targeted spending. The overall budget deficit, including grants and emergency programs, declined from 9.3 percent of GDP in 2001/02 to 8.4 percent in 2002/03 (close to the programmed 8.5 percent). Actual expenditure fell short of the ambitious expenditure targets set for 2002/03 (partly due to lower revenue), but even in this environment poverty-targeted expenditure rose to 15.1 percent of GDP from 14.6 percent in 2001/02, and the share of military expenditure continued to fall. The fiscal framework for 2003/04 has been adjusted to take account of the outturn for 2002/03; specifically, the revenue projections have been revised downwards, and this is compensated for by lower defense spending. The overall deficit and domestic borrowing were maintained at the original program targets.

8. **Staffs welcome the government's continued emphasis on strengthening revenue performance, improving expenditure management, and continuing the reallocation of public expenditure to the social sectors and infrastructure.** On the revenue front, staffs welcome the government's plans to continue efforts to strengthen the functioning of the large taxpayer unit, to strengthen the activities of the tax reform unit, to computerize the tax identification number and the VAT, to put in place enhanced measures to collect tax arrears, and to deal with such arrears, and to reform the customs administration by implementing measures to facilitate the clearance of goods and combat smuggling. Staffs also support the government's efforts to promote export development and plans to join the WTO.

9. **Given the frequency of shocks to the Ethiopian economy, the APR presents three alternative growth scenarios.** The baseline growth projection of the SDPRP projects average annual growth of about 6 percent, and is consistent with the growth required to

⁴ Core inflation, i.e. excluding cereals and pulses, however, amounted to only 3.0 percent.

achieve the income-poverty Millennium Development Goal (MDG).⁵ While this is an ambitious objective, in the view of staffs it is achievable if the government pursues an aggressive reform agenda and sound macroeconomic policies that would promote higher private savings and investment, and provided there is adequate rainfall and a favorable external environment. The baseline growth projection of the SDPRP and the medium term forecast of the PRGF arrangement have been aligned. The high case scenario projects average growth of 7 percent per year, and corresponds to the growth target originally presented in the SDPRP. This target represents a significant increase over the achievements during 1991/92-2001/02 when real GDP increased annually on average by 5.3 percent. In the staffs view, while aiming for higher growth is desirable, for planning purposes the authorities should be more conservative. The low case scenario projects average growth of 4 percent per year. Public revenues and expenditures are estimated for each of the growth scenarios in the APR, and budget allocations are specified.

10. **While the staffs welcome the development of alternative growth scenarios, the implications of these scenarios do not emerge clearly, and further thinking is required to utilize this information to prioritize spending within a realistic medium-term framework.** The APR confirms that the estimated costs of SDPRP programs over the coming two years are substantially higher than projected budget allocations. The implication is that the SDPRP as described is not financable, and depending on the degree of additional aid that can be mobilized, and the performance on reforms and economic growth, targets will have to be adjusted to fit within the available financing. In the view of the staffs, during the coming year, further work is required on: (i) reassessing the affordability of programs within the budget program; (ii) refining the analysis on the sources of growth in Ethiopia; (iii) discussing the key structural reforms required to raise growth; and (iv) refining the alternative macroeconomic scenarios, including the implication for the medium-term fiscal framework.

B. Poverty Reduction

11. **As the APR notes, there is little new data with which to update the assessment of poverty status, and the staffs concur that a period of one year is too short a time to measure significant changes.** However, as noted, a serious drought and continuing low coffee prices have almost certainly resulted in a short-term worsening of poverty in the past year. The APR recognizes the risks to the poverty reduction efforts from factors such as recurring droughts, malaria, and the emerging HIV/AIDS pandemic. The government has done a laudable job of integrating the MDGs into the SDPRP goals in the past year and has

⁵ According to the PRSP, the Ethiopian economy has to grow at an annual average rate of 5.7 percent until 2015 to reduce poverty by half from the level prevailing in 2002, www.imf.org: Ethiopia—Sustainable Development and Poverty Reduction Program, July 31, 2002. Achieving the other MDGs (e.g. health and education) would require, in addition, increases in social sector spending and improvements in service delivery.

undertaken a joint study with UNDP, which indicated Ethiopia needs significant increases in external assistance over the next decade if the MDGs are to be met.

12. **A number of poverty-related studies have been undertaken in the first year of the SDPRP**, including analysis of vulnerability and destitution, and with the assistance of the Fiscal Affairs Department of the IMF, a preliminary Poverty and Social Impact Analysis of the VAT. An informal assessment of the poverty impact of the continuous decline in coffee prices was also undertaken. However the deeper work linking growth, poverty, and sectoral policies foreseen at the time of the original SDPRP could not be completed, partly because the officials involved were occupied in preparation of the food security strategy, and partly because the work proved more methodologically difficult than anticipated. In the view of the staffs, progress on the analytical front has been good under the circumstances in the last year, and there is a credible program for the coming year, including proposals to conduct a Participatory Poverty Assessment during 2003/04, and assessments of the impact on poverty of agricultural extension and credit, food aid, grain prices, and decentralization. Substantial work will still be required over time to better understand the link between sectoral policies and the incomes of the poor.

C. Sectoral Policies

Agriculture and Food Security

13. **The Progress Report accurately reflects progress in agricultural reforms in the past year**, including initial moves to separate extension and fertilizer distribution, phase out regional guarantees for fertilizer credit, and modernize and scale up the agricultural extension system in order to foster specialization and trade. The next steps foreseen by government are to develop specific measures that would further support the commercialization of agriculture and accelerate rural land reform, and to undertake an assessment of the impact of the reforms that have been implemented thus far (e.g. land certification, water harvesting, and the agricultural Technical Vocational Education Training (TVET) program).

14. **Food Security:** The recent drought, combined with a recognition that reliance on large-scale food aid is unsustainable, has led government and its partners to jointly develop a Food Security Strategy as a major new pillar of the SDPRP. The strategy aims to significantly reduce food insecurity, and thereby reduce output volatility, within five years through a combination of increased agricultural productivity, voluntary resettlement, and safety nets. The staffs welcome the incorporation of the strategy into the SDPRP. The challenge now is to articulate the details of the proposed interventions, ensure that program costs are incorporated within the annual budgetary process, and develop quantitative outcome indicators against which annual progress could be measured. The financing options, particularly, should be carefully assessed in view of concerns about the sustainability of Ethiopia's external debt, and the existing burden of domestic debt. While early phases of the resettlement program appear to have gone well, there is concern about the potential effects of a rapid program on the settlers' welfare as the program is scaled up. A major step in the coming year thus will be

the application of the new guidelines for monitoring implementation, and for mitigating the social and environmental risks of resettlement.

Private Sector Development and Financial Sector Reforms

15. **While the primary emphasis of Ethiopia's strategy is still on rural, agrarian-based growth, the past year has seen increasing recognition that poverty reduction depends as much on urban and modern-sector development.** The APR signals encouraging directions, and some specific progress has been made in the past year (notably in the beginnings of telecommunications and energy sector liberalization, of rural and urban land reforms, financial sector reform, in reducing the time and costs of business registration, and in advancing public-private dialogue), but overall movement has been slower than anticipated at the time of the SDPRP. While the Government has prepared an industrial development strategy, it is not a detailed action plan. It would therefore be important over the next year to elaborate the medium-term policies and measures needed for enhancing private sector development. In particular, the government should focus on addressing the impediments to private sector development, foreign direct investment, and exports identified in the recently completed Diagnostic Trade Integration Study (DTIS), which was jointly undertaken by the government and donors. The government will also need to continue to improve access to two key inputs: (i) urban land – where regional legislation and regulations will be needed to take forward the changes introduced by the federal legislation; and (ii) telecommunication services – where a revised policy will need to outline the steps planned for partial liberalization of the sector. In addition, measures to reduce the role of the government in commercially oriented activities will be important; specifically by finding workable ways to privatize the remaining public enterprises.

16. **With respect to financial sector, progress has been made with the adoption of a comprehensive restructuring plan for the Commercial Bank of Ethiopia (CBE).** The challenge is now to ensure the full implementation of all elements of the plan, including (i) the reduction of nonperforming loans (NPLs) to below 20 percent by end-June 2007; and (ii) maintaining the risk-weighted capital adequacy ratio above 10 percent. The government should also: (i) finalize the audit of the Construction and Business Bank (CBB), and finally bring it to a point of sale; (ii) implement the comprehensive restructuring plan for the Development Bank of Ethiopia (DBE); (iii) start implementation of the reform of the National Bank of Ethiopia (NBE), following completion of the comprehensive review of the Bank; and (iv) develop a comprehensive rural finance strategy, with the inclusion of action plans, to improve access to rural finance.

Decentralization and Governance

17. **As noted in the APR, Ethiopia is in the midst of a major shift of responsibility to lower-tier governments.** Experience in the past year has been mixed: decentralization resulted in some difficulties, including inadequate capacity, imbalances in funding, and delays in budgeting, monitoring and reporting, but regions have responded pragmatically and

found short-term solutions. In the staffs' view the APR accurately reflects progress in past year, although it does not take full advantage of the opportunity to assess experience to date.⁶ There remain risks, especially regarding the adequacy of financing at the local level relative to responsibilities, and the one-off costs of establishing local governments. In the coming year it would be important to carefully review these costs, assess the adequacy of block grants, and prepare an assessment of the experience with decentralization in time for the next progress report.

18. **The APR reports on civil service and judicial reform**, although actual progress has been only partially assessed. There is also little assessment of overall progress with key elements of the capacity building initiative, which is one of the major pillars of the SDPRP. In the period ahead, attention should be given to: (i) clarifying further coordination between the Ministry of Capacity Building, key ministries, and regions; (ii) analyzing the utilization of budgeted resources, including a more detailed breakdown of capacity building efforts by region; and (iii) finalizing the design of the capacity building initiative with costed activities across tiers of government.

Other Sectoral Policies

19. **The APR reports on progress in education, including a major push on university and technical training expansion**, defining differentiated approaches for less-developed regions, formulating strategies to improve quality, and beginning to clarify the respective roles of government and private sector in financing education. Principal challenges in the coming year include: (i) arriving at mechanisms to improve student-teacher ratios in the regions; (ii) protecting funding for basic education, especially in the context of block grants to woredas; and (iii) ensuring sufficient allocations to non-salary recurrent needs (textbooks, maintenance, instructional materials, etc.) from those block grant allocations.

20. **In the health sector, advances have been made with the development of basic health packages, and increasing outreach orientation through the Health Extension Worker proposal.** There are, however, continuing concerns about the mix of capital-recurrent spending, and staffing and incentive issues. HIV/AIDS activities have increased in scope and content. The number of communities receiving Emergency AIDS funds has increased, the government adopted a favorable policy on importing anti-retroviral (ARV) drugs, awareness of HIV/AIDS prevention and control has reached almost universal levels, and emphasis is being shifted to behavioral change interventions. However, there are concerns about the slow development of the monitoring and evaluation system, including the

⁶ Although the regional governments, which are responsible for implementing decentralization, are in fact undertaking continuous assessment, and adjusting approaches on an on-going basis.

absence of reliable national survey data, and low capacity to manage and coordinate the efforts of the increasing number of partners.

21. **In the view of the staffs the APR provides a good summary of progress in the past year in the roads sector. It also accurately reflects physical progress in water supply**, but does not address some of the deeper policy and institutional issues, including the non-functioning of large numbers of rural systems, and the financial viability of urban utilities.

22. **The staffs welcome the attention paid to cross-cutting issues in the APR, recognizing that these are difficult for the government to deal with institutionally because they span many jurisdictions.** With respect to the environment, the report describes movement on three proclamations, including in clarifying the role of the Environmental Protection Agency (EPA). The addition of a comprehensive discussion of population issues is also welcomed.

III. MONITORING AND EVALUATION

23. **As noted in the APR, the government made substantial progress in designing a monitoring and evaluation system that aims to link data and analysis with policy review.** The proposal, focusing appropriately on both data generation and dissemination, is being circulated to donors for financing. However, the limited reporting on progress against indicators in this progress report suggests that the functioning of the monitoring and evaluation system is not as strong as might be desired. The challenge ahead will be to make the system operational, especially given the limited capacity of the Welfare Monitoring Unit, and to involve local government in monitoring and evaluation, particularly against the background of fiscal decentralization. It would thus be important that the next APR reports more explicitly on inputs and outcomes.

IV. CONCLUSION

24. **The government of Ethiopia has made significant progress with implementing the SDPRP, and the policy measures of the past year broadly represent an appropriate and credible series of pro-poor structural reforms, although in some areas more could have been achieved.** Furthermore, the SDPRP has become established as the framework for policy formulation, and has accelerated the shift towards a more strategic focus on poverty-reducing policies, and is increasingly forming the basis for harmonized donor support.

25. **The progress report, nonetheless, suggest a few areas where gaps remain in the strategy, and these form an agenda for further work.** It is recommended that the next progress report include the following: (i) a more detailed articulation of measures to accelerate private sector and financial sector development; (ii) a report on progress with rural development, food security, population policy, and land reforms; (iii) further rationalization of the gap between SDPRP program costs and available financing, the inclusion of the costs

of new initiatives (such as food security) in the medium-term plans, and a refinement of the risk mitigation strategy; and (iv) a more detailed vision for further implementation of decentralization, especially addressing the adequacy of block grants relative to obligations. Finally, it will be important to continue to strengthen the monitoring and evaluation system, to deepen the systems for participation of civil society and lower tiers of government in the implementation of the SDPRP, and to develop an understanding of the link between sectoral policies and poverty.

26. The staffs of the Bank and Fund consider that Ethiopia's efforts toward implementation of the strategy provide sufficient evidence of its continuing commitment to poverty reduction, and therefore the strategy continues to provide a credible framework for World Bank and Fund concessional assistance. The staffs recommend that the respective Executive Directors of the World Bank and the IMF reach the same conclusion.