Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: PGD55

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A

PROPOSED DEVELOPMENT POLICY CREDIT
IN THE AMOUNT OF SDR 430.1 MILLION (EQUIVALENT TO US$600 MILLION)

AND A

PROPOSED DEVELOPMENT POLICY GRANT
IN THE AMOUNT OF SDR 430.1 MILLION (EQUIVALENT TO US$600 Million)

TO

THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

FOR THE

ETHIOPIA GROWTH AND COMPETITIVENESS
PROGRAMMATIC DEVELOPMENT POLICY FINANCING

October 3, 2018

Macroeconomics, Trade And Investment Global Practice
Africa Region

GOVERNMENT FISCAL YEAR

July 8 – July 7

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of September 30,2018)

Currency Unit = Ethiopian Birr (ETB)

US$1.00 = ETB 27.69

ETB 1= US$0.036

ABBREVIATIONS AND ACRONYMS

AQR	Asset Quality Review	IDA	International Development Association
CBE	Commercial Bank of Ethiopia	IDP	Internally Displaced People
CEA	Country environmental analysis	IFC	International Finance Corporation
CPF	Country Partnership Framework	IFRS	International Financial Reporting Standards
CSO	Civil Society Organization	IMF	International Monetary Fund
DAG	Development Assistance Group	INSA	Information Network Security Agency
DBE	Development Bank of Ethiopia	IPP	Independent Power Producer
DPF	Development Policy Financing	kWh	Kilowatt-hour
DSA	Debt Sustainability Assessment	LDP	Letter of Development Policy
DSE	Debt service to Exports	MCIT	Ministry of Communication and Information Technology
DSR	Debt Service to Revenue	MoFEC	Ministry of Finance and Economic Cooperation
EEP	Ethiopian Electric Power	MoT	Ministry of Transport
EEPCo	Ethiopian Electric Power Company	MoWIE	Ministry of water, irrigation and energy
EEU	Ethiopian Electric Utility	MW	Megawatt
EIB	Ethiopia Investment Board	NBE	National Bank of Ethiopia
ESIA	Environmental and Social Impact Assessment	NPL	Non-performing Loan
ESLSE	Ethiopian Shipping and Logistics Services Enterprise	PFM	Public Financial Management
ETA	Ethiopian Telecommunications Agency	PPP	Public-private Partnership
ETB	Ethiopian Birr	PSIA	Poverty and Social Impacts Assessment
FDI	Foreign Direct Investment		
FPPA	Federal Public Property and Administration Agency	SCD	Systematic Country Diagnostic
FY	Fiscal Year	SDR	Special Drawing Rights
GDP	Gross Domestic Product	SOE	State-owned Enterprise
GRS	Grievance Redress Service	SSA	Sub-Saharan Africa
GTP	Growth and Transformation Plan	WBG	World Bank Group
IBT	Increasing Block Tariffs	VDT	to Volume Differentiated Tariffs

groupX

Regional Vice President:	Hafez M. H. Ghanem
Country Director:	Carolyn Turk
Senior Practice Director:	John Panzer
Practice Manager:	Mathew A. Verghis
Task Team Leaders:	Nataliya Mylenko, Jean-Pierre Christophe Chauffour, Fernanda Ruiz Nunez

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

ETHIOPIA GROWTH AND COMPETITIVENESS

TABLE OF CONTENTS

SUMMARY OF PROPOSED FINANCING AND PROGRAM 3

1 INTRODUCTION AND COUNTRY CONTEXT 5

2 MACROECONOMIC POLICY FRAMEWORK 7

2.1 RECENT ECONOMIC DEVELOPMENTS 7
2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY 10
2.3 IMF RELATIONS 15

3 GOVERNMENT PROGRAM 15

4 PROPOSED OPERATION 16

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION 16
4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS 17
4.3 LINK TO CPF, OTHER WORLD BANK OPERATIONS AND THE WBG STRATEGY 31
4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS 32

5 OTHER DESIGN AND APPRAISAL ISSUES 34

5.1 POVERTY AND SOCIAL IMPACT 34
5.2 ENVIRONMENTAL ASPECTS 35
5.3 PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS 36
5.4 MONITORING, EVALUATION AND ACCOUNTABILITY 39

6 SUMMARY OF RISKS AND MITIGATION 40

ANNEX 1: POLICY AND RESULTS MATRIX 44

ANNEX 2: IMF RELATIONS ANNEX 49

ANNEX 3: LETTER OF DEVELOPMENT POLICY 52

ANNEX 4: POVERTY AND SOCIAL IMPACT ANALYSIS 67

ANNEX 5: DEBT SUSTAINABILITY ANALYSIS 72

ANNEX 6: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE 76

The Ethiopia Growth and Competitiveness development policy financing (DPF) is prepared by a team co-led by Nataliya Mylenko (Program Leader, AFCE3), Jean Pierre Chauffour (Lead Economist, GMTA4) and Fernanda Ruiz Nunez (Senior Economist, GTIAK), under the guidance of Mathew A. Verghis (Practice Manager, GMTA4), Niraj Verma (Practice Manager, GFCAE), Nicola Smithers (Practice Manager, GGOAE), Pierella Paci (Practice Manager, GPV01), Anderson Caputo Silva (Practice Manager, GFCLT), Sebastian Molineus (Director, GFCDR), Sudeshna Ghosh Banerjee (Practice Manager, GEE01), Lucio Monari (Director, GEED1); Boutheina Guermazi (Director, GDDDR), Aurelio Menendez (Practice Manager, GTR01), Franz R. Drees-Gross (Director, GTRDR), Jordan Schwartz (Director, GTIDR), Paloma Anos Casero (Director, GMTD1), Vivek Suri (Manager, OPSCE), Doerte Doemeland (Practice Manager, GMTMD); Vinaya Swaroop (Economic Adviser, AFRDE), Diarietou Gaye (Director, Strategy and Operations, AFRVP), Mamta Murthi (Director, Strategy and Operations, GGIVP), Akihiko Nishio (Director, Strategy and Operations, GGEVP), Nicole Klingen (Country Program Coordinator (AFCET).

The team includes: Nora Carina Dihel (Senior Economist, GMTA4), Samuel Mulugeta (Economist, GMTA4), Zerihun Getachew Kelbore (Research Analyst, GMTA4), Timothy Kelly (Lead ICT Policy Specialist), James Robert Markland (Senior Transport Specialist, GTR01), Abiy Demissie Belay (Senior financial Management Specialist, GGOAE), Meron Tadesse Techane (Senior financial Management Specialist, GGOAE), Elsa Araya (Senior Public Sector Specialist, GGOAE), Berhanu Legesse Ayane (Senior Public Sector Specialist, GGOAE), Rahul Kitchlu (Senior Energy Specialist, GEE01), Aurora Ferrari (Adviser, GFCDR), Sunita Kikeri (Lead Financial Sector Specialist, GFCFN), Bharatha Manju S. Haththotuwa (Lead Private Sector Specialist, GFCAE), Mengistu Bessir Achew (Operations Officer, GFCAE), Carlo Maria Rossotto (Lead ICT Policy Specialist, GDD11), Rafika Chaouali (Lead Financial Management Specialist, GGOAE), Tuan Minh Le (Lead Economist, GMTA4), Tom Bundervoet (Senior Economist, GPV01), Senidu Fanuel (Senior Private Sector Specialist, GFCAE), Simon Sottsas (Senior Social Development Specialist, GSU07) Nani A. Makonnen (Senior Program Assistant, GMTA4), Sashana Whyte (Young Professional, GMTA4), Keta Ruiz (Lead Operations Officer, GMTDR), Margaret Png (Lead Counsel, LEGAM), Vikram Raghavan (Lead counsel, LEGOP), Paul Jonathan Martin (Lead Natural Resources Management Specialist, GEN01), Berhe Mekonnen Beyene (Economist, GPV01), Dereje Agonafir Habtewold (Environmental Specialist, GEN01), Arden Finn (Young Professional, GPV01), Richard Spencer (Program Leader, AFCE3), Jose Antonio Gragnani (Senior Financial Sector Specialist, GFCLT), Tanya Konidaris (Senior Financial Sector Specialist, GFCLT), Lakech Tsegaye (Country Program Assistant, AFCET), Tsebaot Bekele Habte (Team Assistant, AFCE3), Louise Victoria Monchuk (Senior Economist, GSP01), Laura Campbell (Social Protection Specialist, GSP01).

Peer reviewers for the operation are: Shanta Devarajan (Senior Director, DECVP), Vivien Foster (Senior Advisor, GEEDR), Ishac Diwan (Former, Country Director, Ethiopia).

SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P168566	Yes	1st in a series of 3

Proposed Development Objective(s)

The proposed operation is structured around three strategic pillars: (i) maximizing finance for development; (ii) boosting competitiveness through a better environment for the private sector; and (iii) enhancing public transparency and accountability to promote good governance.

Organizations

Borrower:	FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA - MINISTRY OF FINANCE AND ECONOMIC COOPERATION
Implementing Agency:	FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA - MINISTRY OF FINANCE AND ECONOMIC COOPERATION

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**1,200.00**

DETAILS

International Development Association (IDA)	1,200.00
IDA Credit	600.00
IDA Grant	600.00

INSTITUTIONAL DATA

Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks.

Overall Risk Rating

Substantial

Results

Indicator Name	Baseline	Target
Starting January 2019, all PPP transactions are selected based on transparent and disclosed screening criteria and implemented according to the guidelines approved by PPP board:	No (2018)	Yes (2021)
Power sector has achieved full cost recovery:	No (2018)	Yes (2021)
Institutional restructuring of the power sector completed in concordance with the Sector Reform Roadmap:	No (2018)	Yes (2021)
Power sector losses (commercial and technical):	23% (2018)	15% (2021)
Power sector debt service coverage ratio:	-1.84 (2018)	+1.00 (2021)
Number of days to clear import by customs:	13.5 (2018)	10 (2021)
Number of days to clear export by customs:	5.5 (2018)	4(2021)
Foreign Direct Investment in logistics sector (cumulative):	0 (2018)	US$120 million (2021)
Number of licensees operating in Ethiopian telecom sector:	1 (2018)	3 (2021)
Price of 1GB of data per month as % of gross domestic product (GDP per capita:	12.6 (2018)	5 (2021)
Usage of mobile money, share of age 15+ population:	0.32% (2018)	5% (2021)
Foreign Direct Investment value:	US$3.7 billion (2018)	US$5 billion (2021)
Share of newly registered businesses required to obtain certificates of competence:	100% (2018)	10% (2021)
Share of tradable market instruments in the Government’s total borrowing requirement:	0 (2018)	10% (2021)
All Ethiopian civil society organizations (CSOs) are eligible to engage in Social Accountability activities:	0 (2018)	All (2021)
Number of SOEs that have published on their website timely annual audited financial statements prepared using IFRS:	1 (2018)	9 (2021)

IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT TO FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

1 INTRODUCTION AND COUNTRY CONTEXT

1. **This document proposes a Development Policy Financing (DPF) in the form of an IDA Credit SDR 430.1 million (US$600 million equivalent) and an IDA Grant in the amount of SRD 430.1 million (US$600 million equivalent) to the Federal Republic of Ethiopia.** The proposed operation, first in a programmatic series of three DPFs, is the first World Bank budget support operation to Ethiopia in over a decade. It supports the implementation of the government's Second Growth and Transformation Plan (GTP II) 2016-2020 and advances Ethiopia's strategic vision for becoming a lower-middle-income country by 2025. The DPF supports the acceleration of the government's reform program under GTP II by taking actions to open the private sector for competition and foreign participation, reform state-owned enterprise (SOE) sector and put the economy on a fiscally sustainable path. The reform process is still in its early stage and this programmatic series will allow the World Bank to partner with the Government, both technically and financially, as the reforms gather pace. Given the foundational importance of this first year of these reforms, the Government and the World Bank have agreed to proceed with two tranches. The first tranche will be made upon completion and verification of prior actions, as well as adequacy of the macroeconomic policy framework and satisfactory progress on the program. The second tranche will be made upon completion and verification of specific policy-related tranche-release conditions as well as the adequacy of the macroeconomic policy framework and satisfactory progress in carrying out the program. This enables stronger monitoring of the reform process and macro framework. The proposed operation is aligned with both the World Bank Group (WBG) Country Partnership Framework (CPF) 2018-2022 for Ethiopia and the WBG's twin goals of boosting shared prosperity and ending extreme poverty.

2. **Ethiopia, a growing economy with a population of over 100 million located in the conflict-affected Horn of Africa region, is experiencing an unprecedented political and economic change.** A new Prime Minister came to power in April 2018, during one of Ethiopia's worst political and social crises in decades, which had forced the Government to declare a state of emergency twice in three years. Since his appointment, the Prime Minister has signed a peace agreement with Eritrea and reopened the border following two decades of conflict. The new administration has opened new political space for dialogue, released political prisoners, lifted bans on political parties and media outlets, actively engaged in regional diplomacy, and announced a range of economic reforms designed to revitalize the Ethiopian economy by expanding the role of the private sector. Given Ethiopia's size and location, this shift has transformed the economic and political landscape in the Horn of Africa and the entire continent.

3. **Over the past decade, Ethiopia has achieved substantial progress in promoting economic, social, and human development.** For the last 10 years, the Ethiopian economy has grown at an annual rate of over 10 percent in real terms, making Ethiopia one of the world's fastest-growing economies. This period of robust growth was driven by large-scale public investment in infrastructure and energy, which was made possible by favorable commodity prices and international debt-relief efforts in the mid-2000s. The

poverty rate declined from 55.5 percent in 2000 to 26.7 percent in 2016,[1] and Ethiopia made significant progress on the Millennium Development Goals (MDGs). The primary enrollment rate quadrupled, child mortality rate halved, and the number of people with access to clean water more than doubled. Average life expectancy has increased by about one year annually since 2000 and is now higher than the averages for both Sub-Saharan Africa (SSA) and low-income countries worldwide.

4. **Nevertheless, Ethiopia continues to face serious development challenges.** Maternal and child mortality rates remain high, as does the rate of stunting. Fertility rates in rural areas remain stubbornly high. Access to education has increased, but only 57 percent of children starting first grade will complete ninth grade. Learning outcomes are improving, albeit from a low base, and the quality of education requires further improvement. In addition, Ethiopia hosts more than 920,000 refugees, primarily from neighboring Somalia, Sudan, South Sudan, and Eritrea, and the number of internally displaced people (IDPs) has risen from 1.6 million to 2.8 million since the beginning of this year. While Ethiopia remains one of the most equal country in the world, with a Gini coefficient of 0.33 in 2015, gender disparities are profound, and a combination of cultural norms and socioeconomic inequality greatly increases the risks faced by women. Although poverty rates have converged over time across regions, there are significant intra-regional and inter-woreda disparities. Addressing these challenges requires substantial resources and presses the Government to review current financing model for Ethiopia.

5. **Ethiopia's growth has been driven by public investment and agricultural growth.** The Government has sustained high levels of public investment which has driven strong growth in agriculture and services. This has been financed by tapping external financing, keeping government consumption low and deploying heterodox mechanisms including financial repression. Despite substantial investments in infrastructure to support future growth, Ethiopia's recent economic success has occurred in a context of modest structural economic transformation and private-sector development. Growing macroeconomic vulnerability and reducing fiscal space threaten the long-term sustainability of Ethiopia's growth model.[2] Recognizing the limitations of this approach, the new leadership has announced decisions to expand the role of the private sector, reform SOEs and enhance fiscal sustainability.

6. **The authorities have initiated reforms in key strategic sectors currently dominated by SOEs, opening telecommunications, energy, aviation and logistics to foreign participation and marking a major shift in Ethiopia's economic transformation.** The implementation of these reforms supported by the proposed operation stands to transform the economy by strengthening the role of the private sector, contributing to export expansion and moving towards a sustainable financing model for Ethiopia's growth and development. The government's objective is to sustain the growth momentum of the past decade needed to create jobs for its young and growing population with approximately 2 million new entrants joining the labor market each year.

[1] The poverty rate is measured at the international poverty line of US$1.9 per day in 2011 purchasing-power-parity terms.
[2] World Bank. 2016. *Ethiopia's Great Run: The Growth Acceleration and How to Pace It*. Washington, DC: World Bank Group.

7. **The proposed operation is structured around three strategic pillars: (i) maximizing finance for development; (ii) improving the investment climate and developing the financial sector; and (iii) enhancing transparency and accountability**:

- Actions to maximize finance for development include: (i) promoting public-private partnerships (PPPs); (ii) improving efficiency and restoring financial sustainability in the power sector; (iii) introducing competition in the logistics sector to reduce costs and improve efficiency; and (iv) introducing competition and foreign participation in the telecom sector to improve connectivity.

- Actions to improve investment climate and develop financial sector include: (i) streamlining business regulations conducive to private sector development; (ii) taking actions to remove constraints to access to credit in private sector; and (iii) establishing the government bond market and foreign exchange market.

- Actions to enhance transparency and accountability include: (i) promoting citizen engagement and social accountability; and (ii) improving SOE management, transparency and accountability.

2 MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. **Ethiopia continues to rank among the world's fastest-growing economies.** The real gross domestic product (GDP) is estimated to have expanded by 8.9 percent in FY18 following an increase of 10.9 percent in FY17[3] . Growth is driven by continued growth in services and a strong growth in industry, albeit from a low base (Table 1). Electricity generation increased by 19 percent in FY18, and electricity sales to industry rose by 21 percent, suggesting continued growth in the manufacturing sector. In the service sector, Ethiopian Airlines reported a 21 percent increase in passenger volume and an 18 percent increase in cargo, also contributing to the expansion of exports. Ethiopia remained a favored destination for foreign direct investment (FDI) in SSA.

9. **Ethiopia's total exports expanded by 13.1 percent in FY18 after years of underperformance**. This sharp recovery in exports was driven by the growth in the services exports – that accounted for half of total exports and expanded by 26.6 percent, mainly due to a strong performance of Ethiopian Airlines. Goods exports declined due to weak performance of coffee, which represented 30 percent of goods exports and decreased by 5 percent in FY18 mainly because of a drop of more than 10 percent in coffee prices. Export increases were recorded in the leather, textile and garments, chemical, and electricity sectors, reflecting in part the coming on stream of the industrial parks. Ethiopia exported electronics products for the first time in FY18. The compression of goods imports played an important role in reducing the current-account deficit. (Table 1). Low levels of exports result in liquidity constraints in relation to

[3] Latest available official statistics are for Ethiopian fiscal year 2017 (July 2016-June 2017), World Bank staff estimate for FY18

debt service obligations, despite overall relatively low external debt to GDP ratio of 32 percent. Over the medium-term, expansion of exports is critical to Ethiopia's external debt sustainability as discussed further in the next section.

Table 1. Ethiopia: Key Macroeconomic Indicators, 2014/15-2020/21

	2015	2016	2017	2018(e)	2019(p)	2020(p)	2021(p)
Real Economy	Annual percentage change, unless otherwise indicated						
GDP (nominal local currency)	17.6	24.1	18.1	18.8	17.1	16.3	16.1
Real GDP	10.2	8.0	10.9	8.9	9.1	9.0	9.0
Imports of GNFS (in US$)	25.1	2.9	-4.8	0.2	10.5	10.0	9.5
Exports of GNFS (in US$)	-11.2	-8.1	7.4	13.1	8.7	9.0	10.0
GDP deflator	10.8	10.3	6.3	8.6	7.3	6.7	6.5
CPI (end-of-period)	10.4	7.5	8.8	14.7	9.0	8.0	8.0
Fiscal Accounts	Percent of GDP, unless otherwise indicted						
Expenditures	17.3	18.4	18.3	17.7	17.6	17.5	17.7
Revenues and grants	15.4	16.0	15.0	14.4	14.5	14.6	14.8
General Government Balance	-1.9	-2.4	-3.3	-3.3	-3.1	-2.9	-2.9
Public Debt (end-of-period)	53.4	54.4	57.2	57.2	56.3	54.9	53.4
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated						
Base Money	15.2	16.3	22.7	19.1	--	--	--
Credit to non-government	32.8	22.3	23.0	25.1	--	--	--
Balance of Payments	Percent of GDP, unless otherwise indicted						
Current account balance	-10.2	-9.0	-8.1	-6.5	-6.7	-6.3	-5.8
Imports of goods and services	30.7	27.9	24.0	23.1	23.5	23.6	23.4
Exports of goods and services	8.3	8.0	7.7	8.6	8.9	9.1	9.1
Foreign Direct Investment	3.4	4.5	5.2	4.4	--	--	--
Gross reserves (in US$, eop)	3,249	3,402	3,197	2,847	--	--	--
In months of next year`s imports	1.9	2.0	2.0	1.8	--	--	
External debt	29.4	29.7	29.4	32.3	30.2	28.5	26.7
Exchange rate (average)	20.1	21.1	22.3	25.6	--	--	--

Sources: NBE, NPC, MOFEC, World Bank estimates, 2018.

10. **To support export growth and encourage private-sector development, the National Bank of Ethiopia (NBE) devalued the ETB by 15 percent in October 2017.** The underperformance of exports largely reflects structural issues, such as closed and uncompetitive factor and product markets, but also an overvalued exchange rate. The exchange rate has been rigidly managed to achieve a nominal depreciation path of 5 to 6 percent annually relative to the U.S. dollar, which resulted in an overvaluation of the real exchange rate estimated at around 20 percent by the International Monetary Fund (IMF) in

FY17. Despite tightening of monetary policy, continuing inflation has significantly eroded the real effects of the devaluation over the past year.

11. **Since November 2016, inflation has been increasing driven by base money growth and rising credit.** Base money grew on average by more than 20 percent annually during FY17-FY18. Inflation began to exceed the NBE 8 percent target in March 2017 and reached double-digit in September 2017. In the immediate aftermath of the October 2017 devaluation, the NBE tightened its monetary policy stance to limit the pass-through effect on the inflation rate. It raised the floor on time and savings deposits from 5 to 7 percent and reduced the FY18 growth of base money from 22 percent to 19 percent. Furthermore, the NBE introduced a limit of 16.5 percent on outstanding credit growth extended by commercial banks to firms in the non-export and non-manufacturing sectors in FY18. Despite these measures, inflation continued to rise in FY18 to peak at 14.7 percent in June 2008.

12. **Excess demand for foreign exchange remains substantial.** The exchange rate premium on the parallel market rebounded to its pre-devaluation level of more than 30 percent in the last quarter of FY18. Official gross international reserves decreased to US$2.9 billion at end-June 2018 (below two months of projected goods and services imports) while net international reserves fell below US$1 billion. Reserves are below adequate levels and, taken together with the exchange rate and debt sustainability assessments (DSA), the external position of Ethiopia is weaker than warranted by fundamentals.

13. **The fiscal deficit remained stable at 3.3 percent of GDP in FY18 as the decline in revenues was compensated by strong measures to contain public expenditures.** Federal fiscal revenue decreased both in real terms and as a share of GDP in FY18 due to weaknesses in tax administration, delays in implementing tax revenue increasing policy measures, a decline in trade taxes due to import compression, and a decline in non-tax revenues. With the tax revenue-to-GDP ratio at 11.3 percent, Ethiopia ranks in the bottom third of SSA countries in terms of tax effort. To compensate for lower-than-expected revenue, the Government cut spending during the year and continued to enhance debt management. The authorities prioritized completion of ongoing investment projects, froze all new projects and reduced non-concessional borrowing. As a result, both current and capital expenditures declined. External, largely concessional borrowing financed about 40 percent of the fiscal deficit, while domestic borrowing, including direct advances from the NBE equal to 1.5 percent of GDP, financed the remaining 60 percent (Table 2).

Table 2: Ethiopia Key Fiscal Indicators, 2014/2015-2020/2021

	2015 Actual	2016 Actual	2017 Actual	2018 Estimate	2019 Budget	2020 Proj.	2021 Proj.
Overall balance	**-1.9**	**-2.4**	**-3.3**	**-3.3**	**-3.1**	**-2.9**	**-2.9**
Primary balance	-1.5	-1.9	-2.7	-2.9	-2.5	-2.2	-2.1
Total Revenues and grants	**15.4**	**16.0**	**15.0**	**14.4**	**14.5**	**14.6**	**14.8**
Tax revenue	12.7	12.5	11.6	11.3	11.5	11.7	11.6
Taxes on goods and services	4.0	3.7	3.5	3.4	3.5	3.7	3.7
Direct taxes	4.6	4.7	4.5	4.4	4.5	4.6	4.6
Taxes on international trade	4.1	4.1	3.7	3.5	3.5	3.4	3.3
Non-Tax revenues	1.6	2.7	2.6	2.2	2.1	2.0	2.2
Grants	1.0	0.9	0.7	0.8	0.9	1.0	1.0
Expenditures	**17.3**	**18.4**	**18.3**	**17.7**	**17.6**	**17.5**	**17.7**
Current expenditures	8.3	8.9	9.8	10.0	10.1	10.2	10.1
Defense Spending	0.7	0.6	0.7	0.6	0.6	--	--
Poverty Reducing Expenditures	4.3	4.7	5.0	5.2	5.4	--	--
Interest payments	0.4	0.5	0.5	0.5	0.6	0.7	0.8
Other current expenditures	2.9	3.1	3.7	3.5	3.5	--	--
Capital expenditures	9.1	9.4	8.5	7.6	7.4	7.4	7.6
Domestic sources	7.1	7.1	6.4	6.0	6.0	--	--
External project grants	0.8	0.8	0.7	0.6	0.7	--	--
External project loans	1.2	1.4	1.4	1.2	0.8	--	--
General government Financing	**1.9**	**2.4**	**3.3**	**3.3**	**3.1**	**2.9**	**2.9**
External (net)	1.4	1.7	1.6	1.4	1.2	1.0	0.9
Domestic (net)	1.4	1.6	1.7	2.1	1.8	1.5	1.3
of which: privatization	0.0	0.0	0.6	0.5	0.4	0.4	0.3

Source: MoFEC, 2018.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

14. **The macroeconomic outlook projects continued growth for the Ethiopian economy, as well as the gradual mitigation of its vulnerabilities.** A GDP growth rate of 9.1 percent is projected for FY19, and growth is expected to remain robust over the medium term, albeit somewhat below the levels observed during the past decade (Table 1). While the authorities’ resolve to tighten monetary and fiscal policies going forward may have a contractionary impact on aggregate demand, this is expected to be compensated by the growth effects on the private sector of the structural policies announced by the Government and supported by this DPF.

15. **A policy of fiscal consolidation will be implemented in FY19 that includes no new non-concessional external borrowing and proactive debt management.** The FY19 budget law envisages a reduction in the fiscal deficit to 3.1 percent of GDP. The overall level of expenditure is expected to remain broadly unchanged as a share of GDP. The ongoing reform of SOEs including privatization, implementation of the government's non-concessional borrowing policy, and pro-active debt management aim to create fiscal space over time. The authorities have initiated discussions with creditors to re-negotiate non-concessional debt to reduce interest rates and extend the maturity profile and have already been able to secure improved terms on a portion of the outstanding debt. Over the medium term, the authorities are expected to pursue a gradual fiscal consolidation path to achieve a fiscal deficit below 3 percent of GDP by FY21. The tax revenue-to GDP ratio is expected to increase gradually in sync with the strengthening of tax administration. The Government aims to finance future infrastructure and energy investments through alternative mechanisms including PPPs and direct private participation.

16. **Inflation is projected to ease to about 9 percent in FY19 and continue to decline over the medium term.** Monetary policy is expected to keep the growth of monetary aggregates in line with the potential economic growth rate. Given that the relationship between base money and broader monetary aggregates has weakened with the ongoing financial deepening, the NBE is committed to prudently manage all direct monetary instruments, including the direct advances to the budget, and to strictly adhere to its annual financial programming to avoid the type of deviations that have occurred in the past during implementation. The NBE is also working towards reforming available monetary policy instruments and adopting more indirect instruments of monetary control in the context of the overall financial system reform and modernization.

17. **The management of foreign exchange will remain a key challenge in the coming years.** While the implementation of the tightened fiscal and monetary policies in line with policy announcements will help reduce macroeconomic imbalances, the foreign exchange position will remain fragile and will require the full vigilance of policymakers. As short-term measures, the US$1 billion deposit by the United Arab Emirates at the NBE in July 2018, combined with successful efforts to reach out to the large Ethiopian diaspora and enforcement measures to restrict the parallel foreign exchange market, have significantly improved the foreign exchange situation. The exchange rate premium on the parallel market fell from over 30 percent in June 2018 to around 6 percent at end-July 2018. Going forward, as outlined in the Letter of Development Policy (LDP) (Annex 3), the authorities intend to gradually move towards a more flexible exchange rate management regime to maintain the external competitiveness of the ETB based on the inflation differential with main trading partners and taking into account the terms of trade shocks. The NBE has requested technical assistance from World Bank and IMF to support this process.

18. **Assuming a supportive macroeconomic framework and sustained external global demand, export growth should help rebuild foreign exchange reserves.** Exports are expected to continue expanding in the medium term as the export base expands and large investment projects become fully operational, including the Addis Ababa–Djibouti Railway, as well as several large hydropower dams and industrial parks. The railway will improve trade logistics and reduce transportation costs for imports and exports. It will ship goods between Addis Ababa and Djibouti in just 10 hours, much faster than the three-

to-four days required to ship goods by truck. Meanwhile, the recent commencement of operations at the Hawassa Industrial Park and the second phase of the Bole-Lemi Industrial Park are expected to increase and diversify manufacturing exports. Investments in hydropower, industrial parks, and export-processing zones, as well as policies to encourage FDI and private investment in light manufacturing, are expected to support export growth and diversification. The completion of power lines to neighboring Kenya and Sudan and expansion of power-generation capacity are expected to boost electricity exports and further diversify exports. As a result, Ethiopia's external financing requirements are projected to stabilize at around US$7.5 billion per year during FY19-FY21, allowing for a gradual build-up of foreign exchange reserves (Table 3).

Table 3: Ethiopia Balance of Payments Financing Requirements and Sources, 2016/2017-2020/2021[1/]

	2017 Actual	2018 Est.	2019 Proj.	2020 Proj.	2021 Proj.
	In million US$, unless otherwise indicated				
Financing requirements (in US$)	**7,485**	**6,582**	**7,249**	**7,504**	**7,624**
Current account deficit	6,528	5,502	5,768	5,951	5,980
Short term debt amortizations	--	--	--	--	--
long term debt amortization (excl. IMF)	957.0	1,079.3	1,481	1,553	1,645
Multilateral	56.4	70.6	77.7	90.0	120.1
Bilateral	204.0	98.6	361.9	384.0	438.0
Paris Club	24.7	23.8	25.3	28.6	29.4
Non-Paris Club	179.3	74.8	336.6	355.4	408.6
Commercial	696.5	910.1	1,041	1,079	1,086
Other short term capital outflows		--	--	--	--
Financing Sources (US$)	**8,041**	**6,599**	**8,017**	**8,179**	**8,179**
Foreign direct investment (net)	4,170	3,723	4,584	4,927	5,124
Other flows (net)	492.4	-607.9	-768.7	-168.2	-146.9
Capital grants[2/]	--	--	--	--	--
short term debt disbursements	0	0	0	0	0
Long term debt disbursements (excl. IMF)	3,377	3,483	4,202	3,421	3,202
Multilateral	1,514	1,422	2,129	2,104	2,021
Bilateral	944.8	708.6	1,343	339.9	313.7
Paris Club	61.1	47.9	182.1	180.5	167.4
Non-Paris Club[3/]	883.7	660.7	1,161	159.4	146.3
Commercial	919.2	1,353.2	729.8	976.5	867.4
Change in reserves	**555.6**	**17.4**	**768.7**	**675.3**	**554.4**
IMF credit (net)	--	--	--	--	--

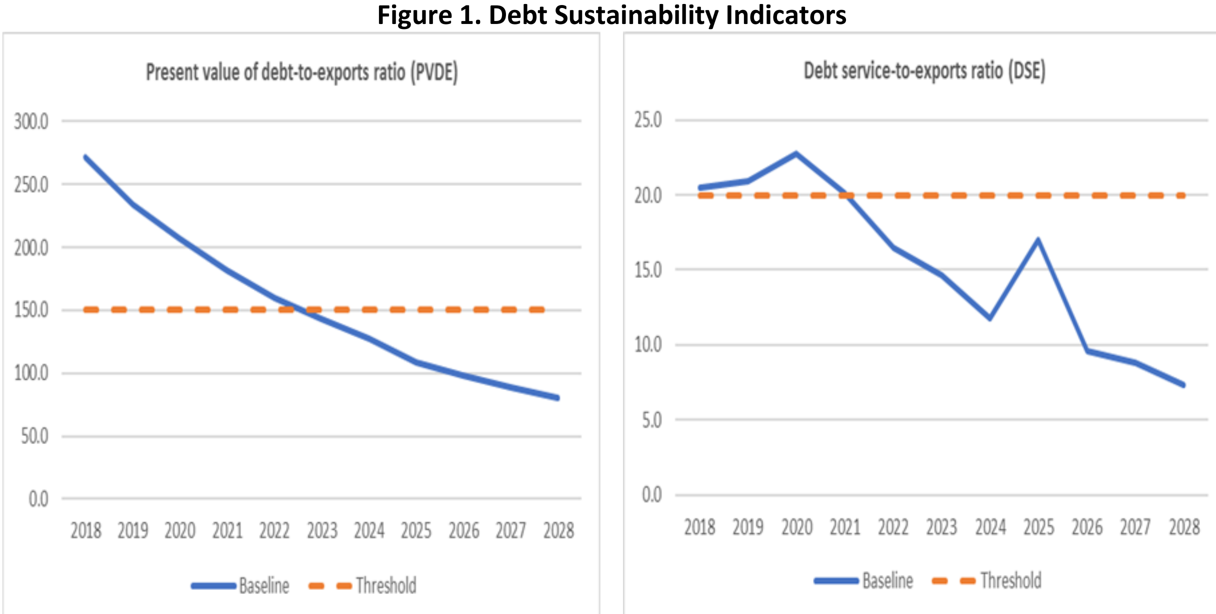
1/ Sources: NBE, WB and IMF estimates.

2/Official transfers in the balance of payments statistics include both current and capital grants but as the breakdown is not available the entire amount is treated as part of the current account.

3/ The US$1 billion deposit made by the Abu Dhabi Development Fund in FY19 is included under Non-Paris Club Bilateral Creditors.

19. **To improve debt sustainability the Ethiopian Government will maintain the policy of zero new non-concessional borrowing and exercise pro-active debt management.** The accumulation of structural external imbalances in recent years caused Ethiopia's risk of external debt distress to be downgraded from "moderate" to "high" in the 2017 DSA. Weak export performance coupled with the maturation of non-concessional loans contracted in the last five years caused debt-sustainability indicators to deteriorate, and the net present value of the external debt-to-exports and debt-service-to-exports ratios breached their indicative thresholds (Figure 1 and Annex 4). However, the Government has since tightened control over non-concessional borrowing. The level of non-concessional borrowing decreased from US$5.8 billion (9 percent of GDP) in FY15 and US$2.2 billion (3 percent of GDP) in FY14 to US$0.6 billion in FY18 (0.7 percent of GDP). In addition, the implementation of the FY17 Public Debt Management and Guarantee Issuance Directive establishes strict oversight by the Ministry of Finance and Economic Cooperation (MoFEC) of new non-concessional borrowing by SOEs. The Government also continues to improve the quality and comprehensiveness of monitoring of its external and domestic debt through regular quarterly publication of the Public Sector Debt Statistical Bulletin. MoFEC is also tasked with monitoring compliance with the FY18 Budget Law and controlling import-intensive investment projects financed on non-concessional terms.[4] The Government is also taking proactive steps to re-negotiate terms on the stock of non-concessional debt.

Figure 1. Debt Sustainability Indicators



20. **Ethiopia's recent achievements notwithstanding, future growth and further gains in poverty reduction and shared prosperity are subject to significant downside risks**. These risks relate to the economic and financial sustainability of Ethiopia's current economic model.

[4] Ethiopia has also established a comprehensive legal framework for debt management that ranks among the best worldwide in the World Bank's Debt Management Performance Assessment (DeMPA), 2013.

21. **Ethiopia's reliance on public-sector demand, especially SOE investment, and repression of market forces, although instrumental thus far in building the infrastructure base of the country, if continued at the same scale, will constrain the growth of investment yields and productivity**. A shift toward greater private sector participation will support diversification, competitiveness, and export expansion from current low base of 10 percent of total export as a share of GDP. A dynamic and competitive private sector will require greater access to finance and a more conducive business environment.[5] The reforms announced by the Government and supported under this operation aim to support the needed transformation with an expanding role for the private sector, reform of SOEs and a gradual shift towards more sustainable financing mechanisms.

22. **Although the general government has maintained financial discipline, the broader public sector evinces serious financial vulnerabilities**. The Government's mix of fiscal, monetary, exchange rate, and structural policies has generated persistent inflation, the overvaluation of the ETB, large external current-account imbalances, foreign exchange shortages, and an elevated risk of debt distress. While the rapid expansion of public infrastructure investment has boosted firm productivity, this approach is reaching its limit in terms of external debt sustainability and the crowding out of the private sector in the credit and foreign exchange markets. Notwithstanding recent improvements in public debt management, including tighter control over SOE borrowing, persistent external imbalances have contributed to an elevated risk of external debt distress. Two of the main credit-rating agencies assigned Ethiopia a single B rating and one a B+ rating, as the country's obligations are subject to high credit risk. The growth projections are therefore subject to considerable downside risks. The steps by the Government to accelerate reform of SOEs to improve governance, management, accountability and financial performance is an important step towards strengthening overall financial sustainability of the economy.

23. **Overall, while substantial downside risks remain and must be addressed properly, the macroeconomic policy framework is adequate for the proposed operation.** The Government has already taken significant steps to deal with the country's elevated risk of debt distress. It has prioritized investment in the allocation of public funding and curbed non-concessional borrowing. The Government intends to achieve and maintain sound macroeconomic policies. Over the next three years, the fiscal deficit will be reduced to put total public debt on a downward path and monetary policy will be managed prudently to restore a track record of single-digit inflation. To sustain inclusive and rapid growth, as well as accelerating structural change, the Government will implement its program of reforming major SOEs including privatization. While Ethiopia has emerged as one of the most attractive investment destinations in Africa in the past few years, the policy announcements since the nomination of the new Prime Minister are expected to further boost the country's attractiveness for private capital. The prior actions[6], second tranche release conditions and indicative triggers selected for this programmatic DPF are therefore

[5] Ethiopia ranked 161st out of 189 countries in the 2018 *Doing Business* report, with major room for improvement in protecting minority investors (176th), starting a business (174th), and getting credit (173rd). Ethiopia also ranked 146th out of 159 countries in the 2017 Economic Freedom of the World index, which identified the legal system, property rights, international trade, and domestic regulation as major areas for reform.
[6] Prior actions refer to the actions completed before Board submission and constitute first tranche release conditions.

designed to support the Government's reform efforts and help mitigate the identified downside risks to the outlook.

2.3 IMF RELATIONS

24. **On January 12, 2018, the Executive Board of the IMF concluded the 2017 Article IV consultation with the Federal Democratic Republic of Ethiopia.** The IMF Executive Directors commended the Government's impressive record of human development improvements and output growth over the last decade, as well as its effective policy response to the recent drought. However, they also emphasized that external imbalances and inadequate reserve buffers remain a key risk and urged the authorities to maintain tight control over external borrowing. Staff from the IMF and the World Bank collaborate closely to monitor macroeconomic development and analyze policy reforms in Ethiopia, holding regular bilateral meetings to exchange information and coordinate activities. Joint recommendations by the World Bank and IMF staff include: (i) promoting a more flexible exchange rate to enhance competitiveness and foster export diversification; (ii) developing a broader range of indirect monetary policy instruments; (iii) promoting an active interbank market; (iv) strengthening domestic revenue mobilization and accelerating tax-administration reform; (v) strengthening the legal framework for PPPs; (vi) improving the business climate, (vii) promoting financial inclusion; (viii) improving economic governance; and (ix) closely monitoring the non-performing loan (NPL) ratios of public banks. During Prime Minister Abiy Ahmed's visit to Washington in July 2018, the IMF's Managing Director commended the Prime Minister for his recent policy announcements and ambitious economic reform agenda. She reiterated the IMF's "commitment to work with the Ethiopian authorities to ensure that the economy achieves high rates of sustainable and inclusive growth to reduce poverty." The 2018 Article IV consultation mission took place in September 2018.

3 GOVERNMENT PROGRAM

25. **The Government's economic program is defined in the 2016-2020 GTP II, which aims to enable Ethiopia to achieve lower-middle-income status by 2025**. The strategy advances reform efforts launched under the GTP I, which focused on boosting agricultural productivity and accelerating growth through large-scale public investment in infrastructure. The GTP II emphasizes the need to maintain high rates of economic growth achieved under GTP I, but it shifts focus to expanding the role of the private sector. The strategy also calls for increasing domestic revenue mobilization through tax reform, exploring alternative mechanisms for financing infrastructure, investment, and strengthening economic governance. The GTP II is designed around four development objectives: (i) achieve an average annual real GDP growth rate of 11 percent in a context of macroeconomic stability; (ii) boost the competitiveness of the domestic economy and facilitating structural transformation; (iii) promote organized public participation in development policy and enhancing public ownership of development outcomes; and (iv) ensure stable democratic processes.

26. **The GTP II encompasses nine strategic pillars**: These include: (i) sustaining the rapid, broad-based, and equitable economic growth and development observed during the past decade; (ii) increasing the economy's productive capacity, competitiveness, and efficiency, with a focus on the agriculture and manufacturing sectors; (iii) accelerating the structural transformation of the domestic private sector; (iv) building the capacity of the construction industry to bridge critical infrastructure gaps and enhance infrastructure quality; (v) properly manage the ongoing process of rapid urbanization and leverage its potential to promote economic growth and structural transformation; (vi) sustainably build human capital and technological capacity; (vii) strengthen democratic processes and promote good governance by enhancing the capacity of the public sector and mobilizing public participation; (viii) empowering women and youth to participate in the development process and equitably benefit from it; and (ix) enhance climate resilience and facilitate the growth of the green economy.

4 PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

27. **The proposed operation will directly support the Government's program, with a focus on maximizing finance for development, expanding the economic role of the private sector, and promoting transparency and accountability**. The proposed operation complements ongoing WBG engagement in Ethiopia in support of the GTP II, a US$11 billion portfolio that includes 38 operations and advisory services and analysis covering agriculture and rural development, urban development, infrastructure, industrialization, climate resilience, social protection, health, education, good governance, and institutional capacity-building. Consistent with the Government's stated development goals, the proposed operation is based on three program development objectives: ((i) maximizing finance for development; (ii) improving the investment climate and developing the financial sector; and (iii) enhancing transparency and accountability.

28. **The proposed operation supports a far-reaching reform program that reflects both the Government's ambitious development goals and the World Bank Group's extensive and deep engagement in Ethiopia.** As the proposed DPF would represent the country's first budget support operation in more than a decade, and given the broad scope of the current World Bank portfolio in Ethiopia, the Government has chosen to focus on recently announced reforms targeting private sector participation and good governance. In this context, the following interdependent filters were applied to guide the choice of sectors and reforms: (i) the relative urgency of reforms; (ii) the presence of strong analytical underpinnings and a good knowledge base to inform the choice of actions; (iii) robust implementation arrangements; (iv) a strong government commitment to implement the reforms within the operation's timeframe; and (v) coordination with other development partners. These filters reflect key lessons learned from the World Bank's extensive experience in preparing DPFs. The implementation of government reforms is supported through an extensive technical assistance program supported by the World Bank, International Finance Corporation (IFC), IMF and development partners.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Maximizing finance for development

29. **The Government's current model for financing infrastructure investment cannot be sustained indefinitely.** In Ethiopia's financial sector, the Government rations domestic credit between competing uses, directing the bulk of domestic bank credit to publicly provided infrastructure and basic services. While this has allowed Ethiopia to greatly increase its public capital stock, it has also led to the rapid accumulation of public debt both external and domestic. Until new assets will generate additional revenues, Ethiopia will face significant liquidity constraints. To sustain high growth rates, Ethiopia needs to identify sustainable ways to finance infrastructure, improve efficiency and enable competition in key economic sectors. This can be achieved by: (i) promoting PPPs; (ii) improving efficiency and restoring financial sustainability in the power sector; (iii) introducing competition in logistics sector to reduce costs and improve efficiency; and (iv) introducing competition and foreign participation in the telecom sector to improve connectivity.

Objective 1.1. Promoting public-private partnerships

30. **Rationale**. PPPs can constitute an important channel not only to improve sectoral efficiency but also to mobilize private financing. This is particularly important in the context of Ethiopia that needs to keep the pace of infrastructure investments while facing liquidity constraints. The Government has implemented PPPs with four PPP projects reaching financial closure with a total investment commitment of over US$124 million.[7] Several projects for investments by Independent Power Producer (IPP) are at an advanced stage of preparation, and more PPP projects have been identified and are currently being prepared.[8] The country has acquired experience in the PPP market but it lacked a solid regulatory framework and institutions to attract private sector operators and leverage private financing while being fiscally responsible. MoFEC has developed a PPP legal framework to promote and sustain private sector participation in the delivery of infrastructure services in Ethiopia. In addition, the Government has been preparing a guiding institutional, legal, and regulatory framework for the identification, selection, and implementation of PPP projects with support from development partners.

***DPF 1 Prior Action #1*: Parliament has approved the PPP Proclamation and MoFEC has issued the PPP Directive to establish a regulatory framework and institutions that manage fiscal risks, enhance transparency, fairness and long-term sustainability in implementing privately financed projects.** *DPF 2 Indicative Trigger #1.1*: The PPP Directorate General issues PPP Implementation Guidelines with the required procedures and authorizations to undertake PPP transactions, including an assessment of the contingent liabilities related to the sovereign contractual obligations.

[7] https://pppknowledgelab.org/countries/ethiopia accessed on August 3, 2018.
[8] See MoFEC, Report for *Public-Private Partnership (PPP) Project Pipeline Screening and Initial Feasibility Assessment of Potential Infrastructure PPPs*, supported by Public Private Infrastructure Advisory Facility and World Bank.

DPF 3 Indicative Trigger #1.2: The Government promulgates procedures and assigns independent authority to review, approve and enforce Environmental and Social Impact Assessments.

31. **Solution**: A strong PPP regulatory framework is central to guide the preparation of well-structured and commercially-viable PPP projects and to ensure long-term value for money for the taxpayers and consumers. Therefore, the passage of the PPP Proclamation by Parliament and the issuance of the PPP Directive by MoFEC (Prior Action #1) are important steps to achieve a more transparent, competitive and efficient process, help manage fiscal risks, improve long term sustainability and where appropriate, increase private sector participation in infrastructure service delivery. Under the new PPP framework, the Government will use the PPP guidelines to prepare, procure and award selected PPP projects that have been prioritized in the PPP project pipeline. The Government's initial focus will be on energy and transport sector PPP Projects, which would expand to other sectors over time. This will instill private sector confidence, bring more competition and ultimately more efficiency to the sector. Importantly, while entering into PPP contracts, the Government may incur fiscal commitments such as direct and contingent liabilities. To manage this fiscal risk, the PPP Directorate General issues PPP implementation guidelines that establishes the procedures and authorizations required for the commitment of government support obligations (direct and contingent liabilities) to PPP transactions (Indicative Trigger #1.1). While the PPP legal framework addresses the need for sound environmental and social impact assessments (ESIA), the establishment of a process and assignment of an independent authority for review, approval and enforcement of ESIAs (Indicative Trigger #1.2) is crucial for the Government to account for environmental externalities and implement risk mitigation measures during the life of the project.

32. **Expected results**: All PPP transactions are implemented according to the guidelines. The fiscal treatment of PPP projects and the independent enforcement of the ESIAs are essential pieces that complement the PPP proclamation and the PPP directives. They provide the overall solid governance that the Government needs to develop the PPP market. These reforms will ultimately help build confidence in the fairness and transparency of the process, leading to greater predictability of the pipeline project quality, instilling confidence in the public and investors, and thereby minimizing risks and increasing investments in infrastructure PPPs and ensuring long term fiscal, and environmental and social sustainability. Implementation of clear environmental and social guidelines for PPPs combined with expected greater levels of investment in sectors supported through PPPs are expected to have positive poverty and social impacts through job creation and better working conditions for employees. It is expected that majority of PPP will be in renewable energy.

Objective 1.2. Improving efficiency and restoring financial sustainability in the power sector

33. **Rationale**. Transition to a competitive and industrial economy will need affordable and reliable energy. Ethiopia is blessed with bountiful renewable energy resources, yet, has the third largest electricity access deficit in SSA and electrification rate of 43 percent. Today, power generation capacity stands at 4,250 megawatt (MW) with about 7,000 MW expected to come on-line by 2020 and over 15,000 MW by 2025. Virtually all the energy in Ethiopia is generated from renewable resources. Ethiopia's National Electrification Program (NEP), launched in November 2017, recognizes the importance of expanding the domestic revenue base, complemented by power exports, to provide efficient and reliable electricity

services to all by 2025. The sector has made incremental strides in the past decade by investing significant public resources, adopting institutional reforms, and gradually opening up to private sector participation. The sector has invested over US$10 billion in power generation, transmission and distribution over the past decade to meet increasing demand (growing at 15 percent per annum). In 2013, Ethiopia separated the monolith Ethiopian Electric Power Company (EEPCo) into Ethiopian Electric Utility (EEU) and Ethiopian Electric Power (EEP). Following the 2018 PPP Proclamation, the private sector will take a central role as financier and implementer of new renewable energy generation plants and could participate in a complementary role in the rest of the sector value chain as well as off-grid service delivery. However, the sector financial fundamentals are compromised by a stagnant tariff regime, lagging operational indicators, and an unsustainable debt management regime. At around 0.03US$/kWh, Ethiopia's electricity tariff is among the lowest in SSA and has remained nominally constant over the past decade. Operational performance, with system losses at 23 percent and collection rate at 85-90 percent, lags international benchmarks and demonstrates significant scope for revenue enhancement. In 2014, the combined quasi-fiscal deficit of the power sector stood at 1.7 percent of GDP.[9] The utilities largely rely on short-term bonds to finance long-term power assets, which has created a cash flow problem and resulting fiscal implications. The power sector's total liabilities stood at about 15 percent of GDP in 2016. The Government has recapitalized EEU/EEP (and their predecessor, EEPCo) three times during the last decade, converting a total of US$1.4 billion (2 percent of GDP) of loans to equity. The Government provided a total of US$1.5 billion in grants for investment. As sole stakeholder, the Government absorbs the utilities' net losses, which reached US$200 million (0.3 percent of GDP) in FY2015/16. Lastly, the GoE guarantees the utilities' debt thus providing implicit subsidies and facing fiscal risks of non-payment. While the direct internationally held debt service obligations of the utilities are generally met on time, most of the domestically held debt is routinely rolled forward – creating risks in banking sector.

***DPF 1 Prior Action #2*: The Council of Ministers has approved a multi-year electricity tariff-increase framework with a detailed implementation schedule to improve cost recovery while protecting the poor.**

DPF 2 Indicative Trigger #2.1: (i) The Government's Macroeconomic Committee has established a Power Sub-Sector Committee to oversee the development and implementation of an institutional reform roadmap in the power sector; (ii) The Ministry of Water, Irrigation and Electricity is implementing a performance improvement plan for improving operational performance in all business areas and with a focus on customer service, optimization of billing, improved collection rates, and loss reduction; (iii) Under the supervision of the EEA, the EEU and EEP carry out reform measures for a second year under the tariff framework.

DPF 3 Indicative Trigger #2.2: (i) The Government's Macroeconomic Committee has approved a reform roadmap for institutional reform in the power sector including recommendations for potential unbundling and privatization of selected power companies; (ii) Pursuant to the reform roadmap, EEU and EEP carry out the restructuring of EEU's and EEP's liabilities; (iii) Under the supervision of the EEA, the EEU and EEP carry out reform measures for a third year under the tariff framework.

[9] Trimble, Chris; Kojima, Masami; Perez Arroyo, Ines; Mohammadzadeh, Farah. 2016. Financial Viability of Electricity Sectors in Sub-Saharan Africa: Quasi-Fiscal Deficits and Hidden Costs. Policy Research Working Paper; No. 7788. World Bank, Washington, DC.

34. **Solution**: For the sector to emerge as an effective complement to Ethiopia's growth and competitiveness agenda, the Government has embarked on a multi-dimensional reform program. First, the Government has taken measures as part of PPP proclamation to attract private sector financing (Prior Action #1, Indicative Trigger #1.1, Indicative Trigger #1.2). Second, –to restore financial sustainability of the power sector, the Government approved and implements a multi-year electricity tariff reforms to achieve medium term cost recovery and reestablish a strong revenue base (Prior Action #2, Indicative Triggers #2.1 and #2.2). Third, the Government will implement critical *institutional reforms* including establishment of a high-level power sector sub-committee as set out in the Privatization Guideline (Prior Action #5) to oversee the preparation of a power sector reform roadmap including unbundling of sector institutions and privatization of selected generation assets (Indicative Trigger #2.1). Fourth, to improve *operational* efficiency, the Government will implement a performance improvement plan to enhance operational performance (Indicative Tigger #2.1). Fifth, and the Government will implement a restructuring plan of the utilities' liabilities (Indicative Trigger #2.2). The power sector reform agenda envisaged by this DPF builds on and is supported by a robust ongoing technical assistance program (financed by grants under the Energy Sector Management Assistance Program (ESMAP); Global Infrastructure Facility (GIF); Public Private Infrastructure Advisory Facility, etc.) as well as nearly US$2 billion IDA investment operations using variety of World Bank instruments –guarantees, program for results, and investment project financing.

35. **Expected results including climate co-benefits**: The reforms in the energy sector will achieve the institutional restructuring of the power sector; improve efficiency on the demand side by increasing average effective electricity tariffs; improve efficiency on the supply side by reducing commercial and technical inefficiencies; and improve financial performance by achieving cost recovery and increasing the power sector debt services coverage ratio. This would ultimately attract FDI and raise export revenues. Consistent with the World Bank's 2016 Climate Change Action Plan and Ethiopia's Nationally Determined Contributions to the Paris Agreement, these prior actions, which relate to efficient pricing of electricity and reduction of system losses, are energy efficiency measures – as a signaling device for the consumers from the demand side and more efficient use of electricity from supply side[10].

Objective 1.3: Introducing competition in logistics sector to reduce costs and improve efficiency

36. **Rationale**: Inefficiencies in trade logistics represent a major challenge to Ethiopia's external competitiveness. The cost of shipping a 20-foot container to Germany from Ethiopia is 247 percent higher than those of Vietnam and 72 percent higher than those of Bangladesh. Ethiopia was ranked 167 out of 190 economies on "Trading Across Borders" indicator in the World Bank Doing Business 2018 and 126 out 160 in World Bank 2016 Logistics Performance Index. In addition to costs, there are two growing pressures that Ethiopia must contend with in relation to logistics: first, the demand for freight and logistics grows at a faster rate than the economy. As such and given the GDP growth rate, demand can be expected to double in less than 10 years. Second, as Ethiopia increasingly participates in global value chains, it is important that the logistics sector be dynamic and responsive to avoid being trapped in the low value segments of the value chains. The market for logistics in Ethiopia has the potential for expansion to

[10] Poverty and distributional impacts of energy tariff reform are described in more detail in Section 5.1.

become a multi-billion-dollar sector that underpins competitiveness, creates jobs, and generates tax revenue for the government. Yet currently the logistics sector is dominated by the state-owned Ethiopian Shipping and Logistics Services Enterprise (ESLSE) which is the only provider of multimodal services, whereby various transport modes are combined under the responsibility of one single transport operator, limiting scope for private participation and competition.

37. **Solutions**: The move towards efficient logistics requires addressing several constraints arising from the current regulatory framework, improving trade facilitation and upgrading logistics infrastructure. The Council of Ministers has approved a National Logistics Strategy defining policy direction for greater competition and foreign participation in the logistics sector with the aim to reduce costs and improve efficiency. To immediately unlock the logistics sector, the Ethiopia Investment Board (EIB) has lifted restrictions on foreign ownership imposed under investment regulations and enabled the provision of bonded warehouse, consolidation and deconsolidation services by allowing minority joint venture participation of international logistics service providers. (Prior Action #3). To broaden competition in the logistics sector EIB will also approve a regulation to allow international logistics providers in industrial parks and logistics clusters and the entry of foreign operators in the freight transportation sector through joint ventures with local logistics services providers. The Ministry of Transport (MoT) will implement a Through Bill of Lading for industrial parks and logistics clusters to allow other logistics service providers to compete with ESLSE (Indicative Trigger 3.1). Ethiopia's trade logistics supply chain is also affected by a number of policies, regulations, and administrative hurdles that considerably undermine efficiency and competitiveness. The Government will finalize the effort to streamline, simplify, and automate the documentation and approval process by introducing an electronic single-window system to cover all regulatory procedures related to trade clearance (Indicative Trigger #3.2).

DPF 1 Prior Action #3**: The Ethiopia Investment Board has lifted restrictions limiting logistics sector to domestic participation only, and permitted minority foreign investment in critical logistics services, including freight forwarding and shipping agency services, warehousing, cargo consolidation, and packaging to foster competition.**

DPF 2 Indicative Trigger #3.1: (i) The EIB permits: (a) the operation of fully foreign owned logistics providers in industrial parks and logistics clusters; and (b) the entry of foreign operators in the transportation sector through joint ventures with local logistics services providers.

DPF 3 Indicative Trigger #3.2: Ethiopia Revenue and Customs Administration: (i) launches the electronic single window system for regulatory procedures in trade clearance; and (ii) introduces a new customs management system.

38. **Expected Results**: Reform of the logistics sector will help reduce time and associated costs to import and export and will attract private (including foreign) investment in the logistics sector. Opening of the logistics sector is expected to attract FDI and help develop new logistics services industry. Greater investment in the sector is expected to have positive impact on poverty in the medium term through generation of new job opportunities. An improved performance of the logistics sector ultimately will contribute to increase in exports. Opening up of the logistics service sector is not expected to have significant environmental effects.

Objective 1.4: Introducing competition and foreign participation in the telecom sector to improve connectivity

39. **Rationale**. Ethiopia is one of the last three countries in the world (along with Eritrea and Djibouti) to retain a national monopoly on all telecom services including fixed, mobile, internet and data communications. Ethio Telecom maintains a monopoly over open-wire telecommunication services, microwave radio relay, cellular mobile services, and radio communication in the high, very high and ultra high frequencies. For many years, Ethio Telecom's monopolistic control has limited the scope for innovation, restricted network expansion and limited the scope of services on offer. As a result, customer service has been poor and the development of new services, such as mobile money, has been slow. Opening the telecommunications sector for competition, attracting investment and putting in place needed regulation is essential to enable digital economy with a significant potential to boost competitiveness, increase exports, create job opportunities and raise fiscal revenue.

40. **Solutions**: Following the announcement of the opening of the telecommunications sector for foreign participation in June 2018 by the Prime Minister, the Government has endorsed a set of policy decisions for telecom sector reform that allows for competition and foreign participation in the sector. This includes establishing and constituting an independent regulator for the telecom sector - Ethiopian Telecommunications Agency (ETA) (Second Tranche Release Condition #1), and preparing the relevant agencies and authorities for the process of privatization in the telecom sector by building capacity, and supporting the Government and Ethio Telecom in considering strategic options The World Bank is financing a full-time legal and regulatory advisor who is assisting in drafting a Telecommunications Reform Proclamation. It is expected that the new Proclamation will be adopted by Parliament before the end of 2018. The draft sets out the membership of the Board of the ETA, and the mechanism for appointment. In parallel, the Government will implement the telecom sector reform, including updating existing legislation and drafting relevant regulations to separate the telecom regulatory functions of the Ministry of Communications and Information Technology (MCIT) (Indicative Trigger #4.1). The ETA will be re-established as an effective regulatory agency, autonomous within government and independent from operators. To complete the privatization of Ethio Telecom and introduce competition, the Government will appoint transactions advisers. ETA will prepare and adopt model license templates and will also work with the Information Network Security Agency (INSA) to formulate and adopt regulations regarding information security (Indicative Trigger #4.2).

DPF 1 Second Tranche Release Condition #1: The **Council of Ministers approves the establishment and constitution of an independent regulator for the telecom sector.**
DPF 2 Indicative Trigger #4.1: The Council of Ministers approves the separation of MCIT's telecom regulatory functions from its service delivery responsibilities.
DPF 3 Indicative Trigger #4.2: (i) The Government's Macroeconomic Committee appoints transactions advisers for telecom privatization and the issuance of additional telecom licenses; (ii) The independent telecom regulator drafts and adopts model license templates; (iii) The independent telecom regulator formulates and adopts regulations regarding information security.

41. **Expected results**: The structure of the telecom sector is expected to change with the introduction of mixed private-public ownership in Ethio Telecom and an increase in the number of licensees in the

telecommunications sector from 1 to 3 or more. These structural reforms are expected to bring benefits to Ethiopian consumers in terms of improving the quality of access, reducing costs and offering new digital products and services. The cost of 1 GB of data per month is expected to decrease and the use of mobile money is expected to increase. It is currently the lowest of all the African countries at just 0.32 percent of adults[11] with the lowest level of female participation at just 10 percent of the total[12].

Pillar 2: Improving investment climate and developing the financial sector

42. **To improve competitiveness, boost exports and create job opportunities for the growing Ethiopian population, the role of the private sector in the Ethiopian economy needs to be strengthened by addressing challenges around the investment climate, financial sector, and the government bond and foreign exchange markets.** The Government needs to ensure that the conditions are in place for a more vibrant private sector. This requires coordinated efforts to improve the investment climate by issuing regulations that reduce administrative burdens for new and operating businesses; taking actions to remove constraints within the financial system to expand credit to the private sector; and initiating the establishment of the government bond and foreign exchange markets.

Objective 2.1: Streamlining business regulations conducive to private sector development

43. **Rationale**: Ethiopia's regulatory environment for business start-up and operation is restrictive, complex and unpredictable. Doing Business 2018 ranks Ethiopia 161 out of 190 countries globally and 31 in Africa. Enterprise creation is constrained by burdensome cost for licensing and registration. Licensing regulations also create undue compliance burden for operating businesses. These regulations impact both domestic and foreign owned businesses operating in Ethiopia. The Investment Proclamation contains barriers to investment entry with restrictions and prohibitions on FDI including telecommunications and transportation. The Commercial Code was enacted in 1960 and it has not been updated since and as a result does not provide legal framework for modern business operations including legal structures, shareholder rights, and other aspects of business establishment operation and closure. Many of its provisions in the areas protecting minority investors and dealing with bankruptcy need considerable overhaul. The legal framework for competition needs to be revised with strong provisions on anticompetitive agreements, abuse of dominance and merger and acquisitions that are likely to harm competition.

44. **Solutions**: The transformational power of the private sector to generate employment and sustain growth will be harnessed through cuts in the red tape and legislative improvements of the business registration, competition, commercial relations and investment legislation impacting both domestic and foreign businesses operating in Ethiopia. To address the licensing and registration constraints, the Ministry of Trade has approved (i) the Directive that reduces by half the number of licensing categories; and (ii) the Directive that eliminates the requirement for competence certificates requirements for at least seventy percent of licensing categories (Prior Action #4). The Council of Ministers will then submit a legislative

[11] World Bank FINDEX 2017.
[12] Poverty and distributional impacts of telecommunications reforms are described in more detail in section 5.1

package to Parliament comprising: (i) a new Investment Proclamation to allow for foreign investment except for a negative list of sectors; and (ii) a new Competition Proclamation to account for enterprises with mixed ownership, eliminate provisions that can be used to control prices, and fight against anti-competitive practices (Indicative Trigger #5.1). To modernize the overall legal framework for business in Ethiopia the Council of Ministers will submit a new Commercial Code to inter alia protect minority shareholders and provide insolvency rules that allow rehabilitation of the debtor's business (Indicative Trigger #5.2).

***DPF 1 Prior Action #4:* The Ministry of Trade has reduced the number of licensing categories by half and eliminated the requirement for annual competence certificates for at least seventy percent of trade-licensing categories, to reduce regulatory burden and simplify business entry impacting over one million businesses.**
DPF 2 Indicative Trigger #5.1: The Council of Ministers adopts and submits new proclamations on investment and competition to Parliament enabling foreign participation in a broader set of economic sectors and enhancing competition.
DPF 3 Indicative Trigger #5.2: The Council of Ministers adopts and submits a new commercial code to Parliament modernizing legal framework for private sector.

45. **Expected Results:** Reform of the investment climate is expected to reduce the regulatory burden on domestic and foreign owned businesses operating in Ethiopia and together with reforms linked to investment and competition proclamation are expected to contribute to the increase in overall investment including FDI. Streamlining of business regulations is also expected to have a positive impact on poverty through job opportunities for employees and through self-employment. Streamlining of licensing requirements supported by this program is not expected to have significant environmental effects.

Objective 2.2: Taking actions to remove constraints to access to credit in private sector

46. **Rationale**: With total assets of 46 percent of GDP, Ethiopia's financial system is shallow and does not serve well the needs of a transforming economy. Access to finance is identified as the main obstacle to business by 40 percent of firms[13]. While the share of adults having a bank account has increased significantly in recent years, it remains at a low 35 percent in 2017 (as compared to 43 percent on average in SSA). Credit to the private sector was at a low 12 percent of GDP in 2017. The banking sector is highly concentrated in terms of market participants and asset portfolio composition. The two state-owned banks, Commercial Bank of Ethiopia (CBE) and Development Bank of Ethiopia (DBE), represent 63 and 6 percent of total banking assets respectively as of end 2017 and serve as a key source of finance for infrastructure investments, SOEs and developmental projects. The banking sector is raising short term retail deposits to finance long term infrastructure projects by purchasing SOE bonds (especially EEP) and extending loans to the same sector. The resulting asset liability mismatch and a high portfolio concentration in specific sectors and enterprises create risks in the system and limits financing to private sector firms. In particular, the interest on EEP bonds that have been purchased by CBE has only been partially serviced since 2015. Instead, interest has been capitalized, undermining the solvency and liquidity

[13] World Bank Enterprise Survey (2015).

of the bank. Private banks are required to buy 5-year NBE Bonds equivalent to 27 percent of all loans disbursed (the "27 percent rule"), the proceeds of which largely go to fund the DBE and reduce liquidity in private commercial banks. The banking system provides a limited range of traditional financial products and services with mobile money or other fintech innovations virtually absent in the market. The financial system also needs to introduce new financial products to support expansion in export, incoming FDI and structuring of PPPs.

47. **Solution:** NBE has initiated a process of developing a roadmap for financial sector development which will identify reforms that aim to deepen the financial sector and ensure that the system is stable and supports the growth of the private sector. The roadmap will provide a vision for the long-term system development aligned with Ethiopia's commitment to join World Trade Organization (WTO). It will include an action plan and timeline for aligning Ethiopia's financial system with international practices in the areas of financial sector regulation, bank and non-bank supervision, financial infrastructure and capital markets development. A critical dimension of the financial system modernization and shifting credit toward private sector is the role of the two state-owned banks and their business model going forward. Some of the challenges faced by CBE and DBE include (i) large exposure of CBE to bonds issued by EEP; (ii) asset concentration at CBE; (iii) high level of NPLs in DBE; and (iv) funding model of DBE through the 27 percent rule. Current operating environment and funding modalities of CBE and DBE contribute to constraints within the financial system and restrict the flow of financing to the private sector. As a first step, the Public Financial Enterprises Agency has directed the CBE to undertake International Financial Reporting Standards (IFRS) compliance audit by an international audit firm. Given the significance of CBE to the financial sector, its asset concentration and risk profile, there is a need for the scope of work of the audit to be enhanced to include an Asset Quality Review (AQR) that assesses, in depth, loan and asset portfolio quality, provisioning adequacy, and provides data and information for strengthening CBE going forward. NBE plans to instruct CBE to expand the scope the IFRS audit to include an AQR. The CBE audit, will be followed up with the approval of an action plan for the bank to improve its operations. The action plan will be approved in year 2 (Indicative Triggers #6.1) and will include an operational, governance, and financial plan. NBE and MoFEC will approve and implement a comprehensive reform plan for DBE (Indicative Triggers #6.1 and 6.2) to address the challenges the bank faces and move towards a sustainable solution in line with a broader vision for the financial system development. Addressing the constraints within the banking system will also help shift more credit supply towards private sector development.

DPF 2 Indicative Trigger #6.1: (i) NBE and MoFEC approve an action plan to implement recommendations from CBE's audit; (ii) NBE and MoFEC approve a comprehensive reform plan for the Development Bank of Ethiopia.

DPF 3 Indicative Trigger #6.2: (i) NBE and MoFEC implement policy reforms under an action plan for CBE; (ii) NBE and MoFEC implement first-year reform measures under the comprehensive reform plan for DBE.

48. **Expected results:** Implementation of reforms in CBE and DBE will help reduce constraints in the banking system and contribute to shifting credit flow towards private sector.

Objective 2.3: Establishing the government bond market and foreign exchange market

49. **Rationale:** A major element of Ethiopia's state-driven development strategy has been to allocate financial resources to the public sector, and to priority economic sectors, using administrative measures and repressing interest rates. While the government's current model of extremely restrictive financial regulation may have been appropriate at the early stages of Ethiopia's economic acceleration, persistently high inflation, negative interest rates on loans to the public sector, and concentration of risks in state-owned financial institutions collectively call its efficiency and sustainability into question. To better serve the financial needs of the economy and limit the Government's financial exposure to SOEs and state-owned financial institutions, financial regulation must evolve towards a more market-oriented approach that promotes the efficient allocation of scarce financial resources. The absence of a market for government bonds impairs the deepening of the financial system. Similarly, to deal with the shortage of foreign exchange, the NBE has issued a series of directives limiting the use of foreign exchange and controlling its allocation. While these emergency measures may help manage short term foreign exchange shortages, they do not constitute a long-term solution to Ethiopia's chronic shortage of foreign currency.

50. **Solution:** Recognizing the limits of its current financial regulatory model, the NBE has begun to adopt corrective measures, including an increase in the interest rate applied on the "27 percent NBE Bill" from the current 3 percent to 5 percent in September 2018. To avoid a piecemeal approach, the NBE intends to prepare a comprehensive framework for the introduction of market-based priced government securities and take steps towards the development of the bond market. The NBE has received IMF technical assistance on the legal and technical requirements to establish such a market, including the drafting of relevant directives. A proper domestic market for government securities could better align the cost of government borrowing with the availability of domestic savings and encourage the Government to improve the value for money of public spending, especially when financial resources are scarce. To this end, the Macroeconomic Committee will endorse a market-based framework for issuing and trading government securities and will implement first measures to introduce tradeable securities (Indicative Trigger 7.1). Regarding the foreign exchange market, adopting monetary and exchange-rate policies that gradually correct the overvaluation of the ETB could help resolve Ethiopia's foreign-exchange shortage. The recent US$1 billion deposit by the United Arab Emirates at the NBE, combined with the government's successful efforts to reach out to the large Ethiopian diaspora, has improved the foreign-exchange situation in the short term. In July 2018, the NBE also re-introduced the gradual depreciation of the ETB, which had been suspended following the October 2017 devaluation. The NBE intends to implement further measures to enable flexible adjustments in the exchange rate targeting real exchange rate competitiveness (Indicative Trigger 7.2). These measures will help ensure that Ethiopia's exchange rate remains consistent with its macroeconomic fundamentals.

DPF 2 Indicative Trigger #7.1: The Macroeconomic Committee: (a) endorses a market-based framework for issuing and trading government securities; and (b) implements first measures to introduce tradeable securities.

DPF 3 Indicative Trigger #7.2: The NBE implements measures to enable flexible adjustments in exchange rate targeting real exchange rate competitiveness.

51. **Expected Results:** With the introduction of a market for government securities, the Government would be able to start partially financing itself through the domestic bond market by the end of the DPF

series. Besides, the NBE will be able to use the secondary market for its monetary and liquidity management operations. Allowing sufficient exchange-rate flexibility will reduce the accumulated overvaluation of the ETB, bolstering Ethiopia's export competitiveness. An effective interbank foreign-exchange market will help address the imbalance between foreign-exchange supply and demand and reduce incentives to use the parallel market, thereby reducing or even eliminating the premium between the official and parallel exchange rates.

Pillar 3: Enhancing transparency and accountability

52. **Transparency and accountability in the conduct of public affairs and access to information by civil society, citizens and the media create a feedback loop that is important in strengthening service delivery,** helping the Government and public enterprises direct resources where the needs and priorities are, and empowering citizens in matters affecting their lives. The third pillar of this operation would therefore aim at: (i) promoting citizen engagement and social accountability; and (ii) improving SOE management, transparency and accountability.

Objective 3.1: Promoting citizen engagement and social accountability

53. **Rationale**. Experience from other countries shows that civil society organizations (CSOs) can be effective partners to governments in improving service delivery and in advocating for various issues on behalf of the public. Historically in Ethiopia, CSOs had played significant role in service delivery, fostering citizen participation, and social accountability. The Ethiopian Charities and Societies Proclamation of 2009 imposed serious organizational, operational and regulatory limitation against CSO work in Ethiopia including restrictions on access to foreign funding and range of activities CSOs can engage in. The combined impact of these regulatory restrictions led to significant reduction in the number of CSOs in Ethiopia affecting service delivery and social accountability. Ethiopia's Freedom of Mass Media and Access to Information Proclamation (2008) acknowledges the right of citizens to access information held by public bodies but omits to specifically refer to availability of data and to proactive disclosure on the part of the public bodies. As a result, public institutions limit their provision of aggregated information and rarely disclose information including on their performance. Even though the open data portal was launched in 2016, the number of datasets and information uploaded on the portal remains limited as a result of the deficiencies in the law.

54. **Solutions**: The Government is reforming the CSO law. The proposed reform recognizes the positive role CSOs play in social and economic life of citizens. The reform includes removal of current restrictions on CSO operations by relaxing funding constraints and expanding range of activities for CSO engagement. The Government has convened Law and Justice Advisory Council at the end of June 2018 composed of experts from academia and civil society. The draft CSO proclamation drafted by the working committee was discussed at a number of regional and federal public consultations with active participation of civil society, academia, international non-governmental organizations (NGOs) and with support from development partners. The draft Proclamation was discussed by the Advisory Council on September 21, 2018 and referred for further revisions by the working committee. The Government is committed to finalize the proclamation through approval by the Council of Ministers and submission to

Parliament (Second Tranche Release Condition #2) on an accelerated schedule but also without compromising integrity of the consultative process, unprecedented for Ethiopia in its scale. It is expected that the Government then will approve the necessary regulations to implement the CSO Proclamation. To achieve the expected results of greater access to information and participation by the public, the Government will submit to Parliament a new Access to Information Proclamation and subsequently approve the necessary implementation regulation (Triggers 8.1 and 8.2).

DPF 1 Second Tranche Release Condition #2: **The Council of Ministers has approved for submission to Parliament a draft CSO Proclamation to promote greater CSO and citizen participation in the development process.**

DPF 2 Indicative Trigger #8.1: (i) The Council of Ministers approves regulations to implement the CSO Proclamation that promote greater CSO and citizen participation in the development process; (ii) The Council of Ministers submits a new Access to Information Proclamation to Parliament to provide citizens with greater access to information and data held by government ministries and agencies in Ethiopia.

DPF 3 Indicative Trigger #8.2: (i) The Council of Ministers has approved regulations to implement new Access to Information Proclamation to provide citizens with greater access to information and data held by government ministries and agencies in Ethiopia

55. **Expected results**: With the new CSO and Access to Information Proclamations, it is expected that CSOs will be fully able to engage in social accountability and service delivery activities. Strengthened CSOs and better access to information would contribute to improved citizen engagement and accountability. Reform of CSO and Access to Information proclamations are expected to have positive poverty and distributional effects in the medium and long run, while being neutral in the short run. The revised CSO law will facilitate increased dynamism and voice of CSOs which often represent socially and economically disadvantaged groups, with the potential to better include these groups in the development process. These reforms are not expected to have significant environmental effects.

Objective 3.2: Improving SOE management, transparency and accountability

56. **Rationale**. SOEs play a key role in the Ethiopian economy and are critical to the delivery of key public goods and services. The 40 wholly state-owned public enterprises are found in key strategic sectors such as infrastructure, industry, construction, and finance, and in competitive sectors such as hotel and tourism, and printing and management services. While some SOEs perform well, others underperform in relation to their mandates and objectives and provide an inadequate return on investment, resulting in inefficient service delivery, financial losses, and debt accumulation. Some SOEs are highly indebted and at risk of defaulting on their debt service obligations. SOEs' underperformance stems from several weaknesses in their governance and management, which result both in the lack of operational autonomy and the lack of transparency and accountability in the use of public assets. Such opacity renders it difficult for MoFEC and line ministries to exercise the proper oversight and due diligence that would lead to better governance of the SOEs. Furthermore, the lack of transparency in the sector makes it difficult for the Government to assess fiscal risks, and/or restructuring needs, to attract private sector funding and enable the Government to meet its privatization targets. Audited financial statements of the SOEs are not disclosed on the websites of Ministry of Public Enterprises (MoPE), MoFEC or on the SOEs' respective

websites. The Public Enterprises Proclamation Law that governs SOEs is outdated and has led to many gaps and shortcomings. These include: lack of a clearly defined rationale for state ownership, lack of clarity about objectives and no clear framework for funding non-commercial objectives, weak state oversight, and low accountability due to dispersion of the state shareholding function across ministries. Some of the largest and strategic SOEs are scattered among nine ministries, which combine the shareholder function with the policymaking and regulatory function. This governance structure gives rise to potential for conflicts of interest, politicized boards and management structures, weaknesses in management performance, and low levels of transparency and disclosure.

57. **Solutions**. The Government is carrying out an ambitious reform program to improve the efficiency and creditworthiness of SOEs around two broad tracks: (i) transforming and partially privatizing strategic SOEs and divesting fully non-strategic SOEs; and (ii) improving the broader regulatory environment for SOEs. Nine SOEs have been identified as strategic for reform which would involve restructuring and/or partial privatization.[14] In June 2018, the Government announced its decision to offer minority share sales in four of the nine strategic SOEs to foreign investors as part of reform.[15] Council of Ministers has issued a Guideline on the implementation of privatization of SOEs which sets out governance arrangements, including designation of the Macro Economic Committee chaired by Prime Minister as the main decision making body and a steering committee chaired by MoFEC Minister with a Secretariat hosted at MoFEC. The Guideline also states key principles to guide privatization including accountability and transparency, setting up adequate policy and regulatory framework that ensure competition, efficiency and sustainability of SOEs (Prior Action #5). In parallel, to improve transparency of SOE debt management MoFEC will expand the scope of its existing debt reporting arrangements to provide detailed coverage of domestic debt of state-owned enterprises including by instrument and debt holder on a quarterly basis and disclose an annual report on public debt including SOE debt consistent with good practice (Second Tranche Release Condition #3). The report on public debt will include a discussion of an action plan to improve quarterly Public Sector Debt Statistical Bulletin and annual Public Debt Report. To support comprehensive SOE reform a new SOE Proclamation in line with international good practice, including the rationale for state ownership, level playing field, governance structures and policies, financing, debt management, performance management, transparency and disclosure requirements will be submitted to Parliament (Indicative Trigger #9.1) and the subsequent issuance of regulation authorizing the creation of ownership entity(ies), such as a holding company (Indicative Trigger #9.2). This will improve Ethiopia's debt reporting which already is one of the strongest in the region, with a current quarterly report that is comprehensive (covering public external and domestic debt including government and SOEs, and guaranteed and non-guaranteed debt), and timely with data having a reasonable three month lag.

[14] These include sugar, railways, shipping and logistics, construction and water, telecoms, airlines, electric power, electricity utility, and industrial parks. The nine strategic SOEs are expected to drive about 40 percent of infrastructure investment required by the GTP II, invest about ETB 900 billion in infrastructure over the plan period, and contribute about ETB 80 billion in fiscal flows.

[15] Ethio Telecom, Ethiopian Airlines, Ethiopian Electric Power (EEP), and Ethiopia Shipping and Logistic Services Enterprise.

DPF 1 Prior Action #5*: The Council of Ministers has approved Guidelines for privatizing SOEs that establish the objectives and principles of the privatization process, clear institutional responsibilities for managing private participation in strategic SOEs, and transparency and accountability provisions.** ***Second Tranche Release Condition #3: MOFEC has expanded the scope of its existing debt-reporting arrangements to (i) provide detailed coverage of domestic debt of state-owned enterprises including by instrument and debt holder on a quarterly basis and (ii) disclose an annual report on public debt including SOE debt consistent with good practice; both by January 2019. *DPF 2 Indicative Trigger #9.1:* (i) The Council of Ministers submits to Parliament a SOE Proclamation reflecting international good practice on state ownership, level-playing field, governance structures and policies, financing, debt management, performance management, transparency and disclosure requirements. *DPF 3 Indicative Trigger #9.2*: i) The Council of Ministers issues a regulation authorizing the creation of ownership entity, such as a holding company with defined mandate, scope, structure, governance arrangements, and financing.

58. **Expected results**: Clear principles set out for the decisions in relation to privatization of SOEs are expected to support implementation of actions in Pillar I of this operation and thus contribute to the results outlined in Pillar I. Better managed SOEs are expected to improve the delivery of critical services for businesses and consumers, reduce the fiscal risks to the Government, protect minority shareholders including foreign, make it easier to attract private sector financing and investment, especially for infrastructure and other critical sectors, and be better equipped to promote economic growth and development. A growing number of SOEs will become IFRS compliant and publish on a timely basis (on respective, MoFEC and MoPE websites) their annual audited financial statements, as well as their Board of Directors' performance report. The reform and privatization of SOEs may have a negative impact on jobs when implemented, but in the medium to long-term is anticipated to increase efficiencies leading to more access and better quality of products and services with overall positive poverty and social impacts. SOE reforms supported by this operation prioritize the establishment of a clear framework which will also include consideration of implications on employment of envisaged reforms. This will help mitigate poverty and social impacts in the future when privatization and reform decisions are implemented. The disclosure of more information on SOE debt will enhance transparency and accountability and is not expected to have significant poverty or distributional impacts. These reforms are not expected to have significant environmental effects.

Table 5. Prior Actions and Analytical Underpinnings

Prior Actions/triggers	Analytical Underpinnings
Pillar 1: Maximizing finance for development	
Promoting Public Private Partnerships (PPPs)	*Best practices on implementing PPPs in power generation: The World Bank (2014). Independent Power Projects in SSA: Lessons from Five Key Countries. Ethiopia's generation investment planning and the adequate role of IPPs: EEP (2014). Ethiopian Power System Expansion Master Plan Study.; World Bank (2017). Ethiopia Grid Management Support Program.; USAID (2018). Ethiopia Power System Planning Modelling Exercise.*
Improving efficiencies and restoring financial sustainability in the power sector	*EEU/EEP's financial performance: EEP/EEU Financial Statements (2008-2016).* *EEU/EEP's financial performance in regional comparison: Trimble et al.*

	(2016). Financial viability of electricity sectors in SSA: quasi-fiscal deficits and hidden costs. The World Bank. *Tariff trajectory: EEP/EEU (2018). Electricity Generation, Transmission and End-User Tariff Adjustment.* *Potential benefits from structural power sector reforms in Ethiopia: Foster et al. (2017). Charting the Diffusion of Power Sector Reforms across the Developing World. The World Bank Policy Research Working Paper; Besant-Jones (2007). Should Electricity Sectors in Developing Countries be Unbundled? The World Bank.*
Introducing competition in logistics sector to reduce costs and improve efficiency	*Africa Development Bank, Analytical Work on Transport Sector in Ethiopia. Growth, Competitiveness and Regional Integration. 201.;* *Government of Ethiopia. National Freight Logistics Strategy for Ethiopia. 2016.* *Maritime and Transport Business Solutions. A Strategy and Transformation Study for ESLSE. 2014.* *Nathan Associates. Development of a National Logistics Strategy for Ethiopia. 2013 (five volumes).*
Introducing competition and foreign participation in the telecom sector to improve connectivity	*WBG 2016 "World Development Report: Digital Dividends"* *MoFEC White Paper 2018 "Exploring policy options for Ethiopia's telecom sector".*
Pillar 2: Improving the investment climate and developing the financial sector	
Streamlining business regulations conducive to private sector development	*WB, Ethiopia Toward the Competitive Frontier, Strategies for Improving Ethiopia's Investment Climate, 2009.* *WB, Ethiopia's Great Run, The Growth Acceleration and How to Pace it, 2014.* *EPPCF/Ethiopia Chamber of Commerce, Ethiopia's National Business Agenda.* *WB, Trouble in the Making, the Future of Manufacturing Led Development, 2018.* *WB, The Cost of Business Registration and Licensing in Ethiopia and Options for Reform, 2016.*
Taking actions to remove constraints to access to credit in private sector	*WB, SME Finance in Ethiopia, Addressing the Missing Middle Challenge, 2015.*
Establishing a government bond market and foreign exchange market	*Documents Produced Under TA for Secondary Market Development for Ethiopian Government Securities from 2016-17, IMF 2018.*
Pillar 3: Enhancing transparency and accountability	
Promoting citizen engagement and social accountability	*Government of Ethiopia, CSO Reform: Diagnostics and Action Options (Draft), 2018.*
Improving SOEs management, transparency, and accountability	*SOE Financial Reporting and Oversight in Ethiopia- Review of Corporate Financial Reporting and Corporate Governance, Mission Report, March 2018.*

4.3 LINK TO CPF, OTHER WORLD BANK OPERATIONS AND THE WBG STRATEGY

59. **This programmatic DPF series aims to address two overarching challenges facing Ethiopia in improving the lives of the bottom 40 percent and fostering faster and more inclusive structural change**

as identified in WBG's 2016 Systematic Country Diagnostic (SCD)[16]. These challenges are the need for a sustainable financing model for growth, and inadequate feedback mechanisms to facilitate citizen engagement and government accountability. The DPF series also directly targets specific binding constraints identified in the SCD including limited credit for private investment and the uncompetitive private sector.

60. **The Ethiopia WBG CPF 2018-2022[17] supports the Ethiopian government GTP II and aligned with the WBG twin goals of eliminating extreme poverty and boosting shared prosperity and achievement of the Sustainable Development Goals (SDGs).** Given the importance of supporting private sector-led growth the CPF was prepared jointly with IFC and Multilateral Investment Guarantee Agency (MIGA). The CPF is organized around three focus areas: (i) Promoting Structural and Economic Transformation through Increased Productivity; (ii) Building Resilience and Inclusiveness; and (iii) Supporting Institutional Accountability and Confronting Corruption. This DPF will help achieve some specific goals set in the CPF including enhanced business and investment climate, improved access to finance for for micro, small and medium enterprises, adoption of new approaches for sustainable infrastructure financing and debt management, and strengthened citizen engagement and holding government entities accountable. The DPF's actions aiming to create more fiscal space also support the objectives of building resilience and inclusiveness by making more domestic public financial resources available to finance social programs and develop buffers for shocks, including natural disasters. The proposed DPF focuses on increasing the role of the private sector and integrating transparency and accountability reinforcing sectoral engagements envisaged in CPF. This DPF with the focus on creating fiscal space, opening up private sector and improving accountability and transparency complements actions already supported through the WBG operations in Ethiopia on social and economic inclusion agenda, human capital development and resilience.

61. **The programmatic DPF will complement ongoing WBG operations in helping to achieve the overall objectives of the CPF**. IDA is Ethiopia's largest provider of official development assistance. In the most recent five fiscal years 32 IDA operations were approved amounting to US$8.4 billion. The portfolio of active projects and analytical work supports national programs on rural and urban safety nets, education, agriculture, sustainable land management, basic service delivery including health, education, agriculture and water sanitation, rural water, sanitation and hygiene program as well as programs in energy transmission, road development, urban transport; water/sanitation, job creation, small and medium enterprises finance, development of trade corridors, urban development and management, public financial management (PFM), statistical capacity development and others.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

62. **Partnerships are a key element of engagement in Ethiopia, and one of the WBG strengths has been in leveraging financing and non-lending support from other development partners for large programs**. Several partners, including the European Union (EU) and its member states, China, Japan, USA,

[16] World Bank Report number 100592.
[17] World Bank Report number 115135.

the IMF, and the African Development Bank, have been engaged, in coordination with the WBG, in providing technical and capacity building support in several areas covered by the DPF (PPP, domestic revenue mobilization, government bond market, public investment management, investment climate, logistics reform, financial sector reform, trade reform, SOE reform and SOE governance). In particular, the DPF series will be coordinated with the budget support provided by the EU. It is expected that a comprehensive and coordinated technical assistance program provided by IDA as well as other donors will be put in place to support the implementation of the DPF series. The existing architecture for aid coordination in Ethiopia, the Development Assistance Group (DAG), will be leveraged to that effect. The DAG hosted a first meeting to discuss this operation on August 30, 2018.

63. **The pillars of the DPF and actions have been based on a consultative process across different departments of the Government, as well as wider stakeholder groups within the country.** The proposed DPF supports the implementation of the GTP II, preparation of which was informed by extensive consultations at federal level and in all regions, involving broad set of stakeholders including youth, women, farmers, private sector, CSOs, academia and development partners. Consultations were held by the Government in relation to key new regulatory initiatives supported by this DPF. The proposed new electricity tariff framework was discussed during the public consultation meeting convened by the Government in August 2018 with representatives of Government's ministries, industrial and commercial associations, civil society, regional energy bureaus, development partners. The consultation was covered by the media. The Law and Justice Advisory Council set up to provide policy recommendations on amending the CSO and anti-terrorism laws held broad based public consultations with members of the academia, legal professionals, representatives of CSOs and political parties unprecedented in their scale and intensity in Ethiopian context. Regulations and directives on PPP, business regulation, logistics and financial sector reforms were informed by extensive consultations the Government had with private businesses associations and financial institutions.

64. **The Second Growth and Transformation Plan (GTP II) as the overarching framework for the country's growth and transformation agenda is a major platform for consultation and dialogue between the government and various stakeholders and the population at large**. Following a two and half years of implementation of the GTP II, the government has embarked on a broader consultation at federal and regional level with stakeholders. The consultation involved reviewing the performance of the last two years in the context of the target for the end of the plan period, and potential adjustments and changes required for the remaining plan period. The National Planning Commission has spearheaded the consultations with government institutions, academia, various civil society groups and community representatives. This review is expected to be enriched with forward looking policy changes and adjustments as announced recently by the Ethiopian government.

5 OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

65. **Overall, the proposed DPF supports policy and institutional changes that are likely to have poverty-reducing effects in the medium term, though there will also be distributional impacts that should be addressed (see also Annex 4).** This is particularly true of the policy reform of electricity subsidies, which is expected to have the largest direct impact of all the proposed changes. The implications of the other structural reforms are likely to have some potentially positive significant poverty and distributional implications. Improvements in the business and private sector environment through PPP and SOE reform, and through addressing some of the key constraints to business operations are expected to boost the establishment of new enterprises and lead to a higher level of foreign investment. This should help to create additional jobs which will go some way to helping to absorb the approximately 2 million young Ethiopians who enter the labor force each year.

66. **The electricity tariff prior action is expected to have poverty reduction and positive distributional impacts in the medium-to-long term, but it may have some negative distributional impact in the short run. To minimize the impacts to the most vulnerable consumers, lifeline tariff will remain unchanged.** Adjusting the tariff structure of electricity will increase available fiscal space and improve the welfare of Ethiopians in the medium-to-long-run, but it will have some negative impacts across the distribution of welfare in the short-run. The current structure of tariff subsidies is regressive, meaning that the benefits are more heavily skewed towards the rich than they are towards the poor. This is in contrast to most other government expenditure. The proposed adjustment of tariffs will see price increases that are relatively larger for high users than they are for low users, reducing the regressive nature of the subsidy. Moreover, the Government will not change the (lifeline) tariff for the most vulnerable consumer in block 1 (up to 50 kWh). While purchasing power of the urban poor would also be reduced, albeit marginally (Annex 4), by the reform, a significant share of the urban poor will be shielded from this by their participation in the IDA-supported Urban Productive Safety Net Project (P151712). The tariff reform will also allow the electricity provider to become more financially sustainable and to use additional revenue to expand and improve access, mainly to underserved rural areas.

67. **There are potentially indirect poverty-reducing effects that may arise from improving telecommunication services.** An underdeveloped information and communication technology (ICT) sector has been flagged as one of the constraints to firm and job growth in Ethiopia (World Bank, 2016). Improving the regulatory environment while allowing for greater competition and increasing private sector participation in the sector can be expected to improve service delivery for households and businesses. Addressing the current inefficiencies, as proposed in the DPF, should ensure that there is progress towards growth and job creation that is led by the private sector. Enhancing the competitiveness of the sector will have medium-run impacts on poverty and inequality through the channels of prices, wages of the employed, and job creation.

67. **The focus of this poverty and social impacts assessment (PSIA) has been on short-run effects, but there are also longer-term questions about competition, job creation, prices and access that will be addressed in future rounds.** The context of the current reforms being made at a rapid pace in a state-led economy means that both direct and indirect effects will be important. The *ex-ante* effects of these reforms will be analyzed as the specifics become clearer. Similarly, future rounds of reform in the telecoms sector will form the basis for modeling the welfare impacts of changes in market structure. Finally, given that there are some potentially negative short-run impacts, the issue of mitigation measures will receive closer consideration.

5.2 ENVIRONMENTAL ASPECTS

69. **The reforms supported by this operation are expected to accelerate private sector investment, with potentially significant effects on the environment and natural resources.** The policy actions most likely to cause downstream environmental and social effects include those promoting PPPs, streamlining business regulations, and facilitating investment. These effects are detailed in Annex 6. These actions need to be viewed in the context of Ethiopia's weak institutional capacity to manage and control potentially negative effects of investment projects, in particular the weak system for conducting ESIAs and enforcing compliance with the results.

70. **WBG Country Environmental Analysis (CEA).** The World Bank's CEA (2017) notes that Ethiopia's development transformation requires better integration of environmental and sustainability considerations into policy and institutional frameworks to achieve efficient use of resources that contribute sustainably to economic development, poverty reduction and quality of life. The CEA also outlines policies that would contribute to overall efforts to improve environmental outcomes, including a strengthened ESIA process, and the use of economic incentives and provision of information as instruments to encourage environmental improvement. A key issue is the delegation of the authority to review, approve, monitor and enforce ESIAs to the sectoral ministries responsible for investments in agriculture, industry, mines, energy and infrastructure, creating a significant conflict of interest.

71. **The assignment of independent authority to review, approve and enforce ESIAs is included in the third operation in this series (Indicative Trigger #1.2) and it will play a crucial role to ensure that PPPs are environmentally sustainable**. Additional measures recommended in the CEA include the mandatory disclosure of ESIAs, and the extension of this requirement to related monitoring reports to facilitate compliance monitoring and public access to information on environmental and social impacts. Continued efforts to build capacity at the federal, regional and local levels for environmental management and enforcement will also be important. In this regard, the World Bank is providing technical assistance for environmental management and social protection in Ministry of Environment, Forest and Climate Change and key line ministries, as well as support to improve the regulation and certification of industries, with a focus on compliance monitoring and certification of industrial parks.

72. **Ethiopia's Nationally Determined Contribution aims to reduce national emissions by 64 percent by 2030 as compared to business as usual scenario[18].** However, rising energy demand from domestic,

[18] http://www4.unfccc.int/ndcregistry/PublishedDocuments/Ethiopia%20First/INDC-Ethiopia-100615.pdf.

commercial and industrial users and high commercial and technical losses from transmission and distribution, threaten this trajectory. The DPF promotes policy actions to ensure future investments in energy are not only fiscally sustainable but also maintain country's medium to long term low emissions pathway and generate climate co-benefits (since Ethiopia has been exclusively meeting its electricity needs with renewable energy). The Prior Actions #1 and #2 are aligned with the multilateral development banks methodology on climate mitigation finance.[19] Under Prior Action #1, several projects will be considered for competitive procurement and majority are expected to be IPPs for renewable energy generation. Under Prior Action #2, the implementation of the multi-year electricity tariff regime promotes efficient pricing of electricity and it is eligible for mitigation co-benefits under the category of support to national, regional or local policy, through technical assistance or policy lending of the multilateral development banks methodology on climate mitigation finance. In the successive DPF series, climate benefits will also emerge from reduction in technical losses, envisaged under the performance improvement plan (Indicative Trigger #2.1).

5.3 PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING ASPECTS

73. **Over the past few years, the Government has demonstrated a credible commitment to modernize and reform its PFM and enhance its efficiency and effectiveness**. Responsibility for ensuring that the PFM system is designed to achieve this purpose has been with the MoFEC through its expenditure management and control program (EMCP) – one of the five key reform initiatives under the civil service reform program. The public procurement is regulated by the Public Procurement and Property Administration Proclamation no. 649/2009, which establishes the federal public property and administration agency (FPPA) as a body responsible for regulation and monitoring of public procurement activities. All the nine regional states and two city administrations have their own procurement proclamations and directives which are drafted using the federal framework as a prototype. Furthermore, the Government has instituted several reforms to reduce corruption through the Federal Ethics and Anti-Corruption Commission (FEACC) established in 2001 (Proclamation No. 433/2005 as amended by Proclamation No. 880/2015) and the creation of the Federal Attorney General's position in 2006 (Proclamation No. 943/2016). Since 2007, all the nine Regional Governments have established their own Regional Ethics and Anti-Corruption Commission (REACC) per the regional law.

74. **To strengthen the PFM system, a systematic approach to reform has been taken by the Government focusing on "getting the basics of PFM right".** The Government began the reform process with the reform of the legal framework and the issuing of updated directives and regulations covering all aspects of the PFM cycle. The result has been a steady strengthening of PFM systems over the last ten years. This progress has been noted in the latest Public Expenditure and Financial Accountability (PEFA) conducted in 2015 which ranked Ethiopia in the top 10 percent of countries in the Africa region in terms of accountability and adequacy of the PFM system. Furthermore, audit coverage at the federal level has increased and audit reports are produced in a timely manner. At the federal and regional levels, fiscal

[19] https://www.worldbank.org/en/news/press-release/2018/06/13/mdb-climate-finance-hit-record-high-of-us352-billion-in-2017.

spending reports are prepared monthly with no more than a four weeks' lag, and quarterly reports are available two weeks following the end of the quarter. In addition, Ethiopia has developed a robust legal framework for addressing fraud and corruption risks although in practice corruption remains a roadblock to institutional accountability and governance.

75. **Despite noted improvements and progress, there remain important weaknesses in the PFM system.** The main weaknesses identified at the federal level relate to tax collection, public access to budget information, medium-term perspective in budgeting, unreported extra-budgetary funds[20] as well as limited parliamentary oversight. Procurement processes are also characterized by several weaknesses which undermine its efficiency and effectiveness. These include a limited regulatory capacity of FPPA, delays in procurement processes, inadequate application of evaluation criteria, uneven use of standard bidding and contract documents, absence of recognition of procurement profession in the civil service, lack of experience and qualification of procurement professionals, and weak contract administration capacity and practices.

76. **To further strengthen the PFM system and implement the recommendations from various diagnostics, the Government has developed a PFM reform strategy.** The strategy covers a five-year period from 2018-2022 with the aim "to modernize the PFM system in Ethiopia, promote its transparency, accountability and equity and enhance its efficiency and effectiveness". The World Bank is also supporting the Government in its efforts to reform and strengthen the procurement as well as the overall PFM system.

77. **There is no recent IMF Safeguards Assessment of the NBE.** The latest IMF safeguard assessment dates to 2009. The organizational structure of the NBE is headed by a board, three vice governors (Research, Supervision and Corporate Services) and multiple directors for the oversight and implementation of the NBE's role. The Foreign Exchange and Reserve Management directorate is responsible for managing forex related activities and reports to the Research Vice Governor with relevant directives guiding its operation. The NBE has an Internal Audit and Risk Management directorate which reports to the NBE's Board and conducts risk-based audit and follows up on actions taken. The World Bank investment credits have been channeled in a satisfactory manner through designated accounts maintained at the NBE.

78. **The NBE started publishing its audited financial statements in 2014 and has an up-to-date audit report.** The recent audit report for the year ended July 7, 2017, prepared by the Audit Services Corporation, was issued on December 19, 2017 and is unqualified. The auditors have reviewed the internal controls around the preparation and presentation of the financial statements and have communicated the deficiencies to those charged with governance. These findings are being followed up by the audit and risk directorate. The Board of NBE has an audit committee comprising two to three members but is not currently operational. Consequently, the Audit and Risk Directorate reports on the audit follow up actions directly to the governor.

[20] Such as Road Fund, Social Security Agency Fund, Oil Stabilization Fund, Industrial Development Fund and Sugar Development Fund.

79. **Overall, the fiduciary risk of the proposed operation is considered substantial.** This rating is based on the status of the Federal Government of Ethiopia's PFM system noted above, the current country PFM risk rating per the World Bank financed operations, and the NBE's internal control assessment. The World Bank portfolio risk rating is substantial mainly due to weak capacity, staff turnover at the public bodies, weak internal audit function, challenges in procurement and property management as well as weakness in resolving repetitive audit report findings on time. Other factors of the risk rating include limited transparency and weak reporting by the SOEs.

80. **Budget disclosure.** The budget process for the Federal Government of Ethiopia has improved through the years as reported in the 2015 PEFA assessments. Public access to government budget information has improved. Yearend financial statements and external audit reports are being published on MoFEC's website and in the Government's official publication (Annual Budget gazette). Public disclosure of the annual government budget prior to its submission to parliament is lacking. However, once the budget is submitted to the Parliament, the latter calls for public participation in public hearings and conducts open sessions.

81. **Disbursement and Accounting.** The Recipient is the Federal Democratic Republic of Ethiopia, represented by the MoFEC.

- *Disbursement*. The proposed operation will follow IDA's standard disbursement arrangements for DPFs. After IDA's Executive Directors approve the proposed financing and the Financing Agreement has become effective, the Recipient will be entitled to withdraw the IDA Grant and IDA Credit in two tranches. The conditions to disburse the First Withdrawal Tranche include the completed and verified prior actions, the adequacy of the macroeconomic policy framework, and satisfactory progress in carrying out the Recipient's program. Disbursement of the Second Withdrawal Tranche will require evidence of completion of specific policy-related tranche-release conditions as well as the adequacy of the macroeconomic policy framework and satisfactory progress in carrying out the program. The first withdrawal tranche under IDA Grant will be SDR 286.7 million (US$400 million equivalent) and a similar amount of SDR 286.7 million (US$400 million equivalent) will be available as the first withdrawal tranche under the IDA Credit. The second withdrawal tranche under the IDA Grant will be SDR 143.4 million (US$200 million equivalent) and a similar amount of SDR 143.4 million (US$200 million equivalent) will be available as the second withdrawal tranche under the IDA Credit. Financing proceeds will be disbursed by IDA into a dedicated government account for budget support at the NBE, which will form part of the country's foreign-exchange reserves. The authorities will credit an equivalent amount in Ethiopian currency to the government budget. The financing proceeds will not be used to finance expenditures excluded under the Financing Agreement.

- *Reporting*. The Recipient shall ensure that upon the deposit of the Financing proceeds into the government's foreign currency account, an equivalent amount is credited in the Recipient's budget management. The Recipient will report to the World Bank about the amounts deposited in the foreign-currency account and credited in local currency in the Government's treasury account to the budget management system. The Recipient will promptly notify the World Bank within thirty (30) days of the transfer by fax or email that the transfer has taken place and that proceeds have been credited in a manner satisfactory to the World Bank.

- *Excluded expenditure*. If, after being deposited in dedicated government account, the proceeds are used for excluded expenditures as defined in the Financing Agreement, IDA will require the Recipient to refund directly to IDA an amount equal to the amount of that payment promptly upon notice. Amounts refunded to the World Bank upon such a request will be canceled.

- *Audit of the deposit account*. The Government shall submit an audit of the deposit account by independent auditors acceptable to the Association. The Recipient would: (i) furnish to the Association as soon as available, but in any case not later than three months after the year end, a certified copy of the report of such audit, of such scope and in such detail as the Association shall reasonably request, and make such report publicly available in a timely fashion and in a manner acceptable to the Association; and (ii) furnish to the Association such other information concerning the Dedicated Account and related audit as the Association shall reasonably request.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

82. **MoFEC will be the coordinating institution for monitoring and evaluation among all the participating ministries and Federal Government agencies.** Given that the institutional and policy reforms supported by the programmatic DPF series fall under the purview of five ministries (MCIT, MoFEC, MoPE, MoT and Ministry of water, irrigation and energy (MoWIE) and several Federal Government agencies, a Project Coordinating Committee was established for overseeing the preparation of the operation. This Committee will remain in place during the implementation of the program and until completion of the DPF series. MoFEC is responsible for coordinating the work of this Committee and will coordinate with other ministries and agencies the monitoring of the results indicators and evaluation activities.

83. **Data availability and quality are appropriate to monitor progress of the DPF Program.** The program outcomes will be monitored through results indicators as detailed in the Policy and Results Matrix (Annex 1). Most of these results indicators are based on routinely published information and for those that are not, the concerned ministries or agencies will be responsible for collecting the data, tracking the relevant indicators and providing these to the MoFEC on a timely manner. MoFEC will be responsible for submitting such information at a frequency and in a format satisfactory to the World Bank. The World Bank will provide implementation support, including technical assistance in needed reform areas as described above, to ensure timely implementation and adequate data collection and monitoring of indicators and outcomes of the program.

84. "**Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank DPF may submit complaints to the responsible country authorities, appropriate local/national **grievance**

redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org. "

6 SUMMARY OF RISKS AND MITIGATION

85. **The overall risk rating of this operation is substantial.** The major risks to achieve the development objectives of this operation include high risk in political and governance risk; and macroeconomic risks related to high level of external indebtedness and weak revenue performance. There are also substantial risks in sector strategies and stakeholder; weak institutional and implementation capacity, substantial fiduciary risk, environmental and stakeholders risks.

86. **While the overall political environment has substantially improved after the election of the new Prime Minister in April 2018, it remains challenging with several ethnic-based conflicts occurring in different parts of the country.** The widespread civil unrest and violent demonstrations that mainly affected the two large regional states of Oromia and Amhara over the past couple of years have now subsided. The state of emergency that was imposed for the second time in about a year in February 2018 was lifted in June 2018. There is an opening of the political space with prominent opposition parties and personalities coming back from exile to take part in the political process. Freedom of expression also improved with several private and state media reporting on political issues. Despite these positive developments, ethnic-based localized conflicts continue to occur in different parts of the country. Escalation of conflict may pose significant risk to the political and governance environment and to the economic performance. The World Bank carefully monitors the political and governance situation in the country with the view to take appropriate mitigation measures in case these risks materialize.

87. **As noted in the macroeconomic policy framework section, major macroeconomic risks are largely related to the external and fiscal sectors.** Export performance has been weak over the past few years mainly due to structural and competitiveness issues including rigid factor and product markets and an overvalued exchange rate. Although the Government has been making significant investments including in energy and the development of industrial parks to boost manufacturing exports, Ethiopia's exports sector continues to be highly concentrated in few agricultural commodities making it highly prone to shocks related to movements in global commodity prices. The weak export performance coupled with the relatively large stock of non-concessional borrowing to finance infrastructure investments by SOEs have led to a "high risk" of debt distress since the 2017 DSA. Efforts towards maintaining a competitive exchange rate, strictly adhering to the commitment of no new non-concessional borrowing, and accelerating structural reform are critical to preserve external balances.

88. **The Government's future reform directions in key sectors is likely to face resistance from vested interests.** While the Government's intention to allow private participation in power, telecom, transport, and logistics is a positive development and elaboration of the decision-making process and key principles guiding privatization provides a strong signal on the direction of reform, implementation of the decision will face challenges from vested interests within the sector. SOE reforms are politically contentious and can be challenging to implement. There are many vested interests within government (e.g. ministries, other government bodies) and SOEs (boards, management, employees) that may attempt to stall reform. External stakeholders such as suppliers, customers, and others might object to greater transparency in SOE commercial dealings. CSOs may also resist change toward liberalization and private sector development. Mitigating these risks will require sustained political leadership and commitment, phasing and sequencing reforms based on the political and institutional feasibility, building institutional capacity to manage and sustain the reform process, supporting improvements at the company level, publishing comprehensive data on SOE performance, and building support for reform among stakeholders and the public. The Government has sought technical assistance from different stakeholders, including the WBG, to support the implementation of the reforms and ensure sound analysis and consultative process as part of the decision-making process.

89. **Weak institutional and implementation capacity is a major risk.** As Ethiopia is striving to gradually move away from a heavily public sector dominated model towards a more open environment with strengthened private sector participation, the human, technical, and technological capacity of the ministries and government agencies to carry out the required reforms is an important concern. The Government needs to make significant efforts towards addressing these capacity constraints. Technical assistance from several stakeholders, including the WBG, are expected to mitigate this risk to some extent.

90. **As detailed above, fiduciary risks are substantial but are being mitigated and closely monitored.** The substantial risk rating is based, on the status of Government's PFM and procurement systems, the current country procurement and PFM risk rating per the WBG financed operations, and the NBE's internal control assessment as reflected in the most recent audit report for the year 2017. The deficiencies in the internal control system reported by the audit are being followed up closely by the NBE management and do not have a major bearing on the use of this operation's proceeds. In addition to the on-going progress in strengthening the PFM system through the implementation by the Government of a PFM Reform Strategy, the WBG is supporting the Government in its efforts to reform and strengthen the procurement as well as the overall PFM system through on-going WBG-financed operations and technical assistance. Progress on these fronts is being monitored closely by the Government and its development partners including through the PFM Donor Working group and the WBG's implementation support of its on-going operations.

91. **Environmental and social risks are rated as substantial.** The economic transformations proposed by the GoE may lead to disruptions of people's livelihoods and consequent grievances; this relates to increased electricity tariffs, foreign exchange fluctuations, potential impacts on small-scale service

providers in the logistics sector, and employment retrenchments in SOEs. These issues can be addressed through measures to (i) continuously monitor potential impacts; (ii) establish mechanisms to protect vulnerable people from adverse social impacts; as well as (iii) strategic communication and consultation with respective stakeholders. The World Bank through its engagement in development projects will provide continuing technical assistance and capacity building together with development partners. In addition, the sectoral reforms need to be accompanied by improvements in the environmental and social regulatory framework to avoid adverse effects on the environment and natural resources and on vulnerable of the population, and promote public participation in decision making about investment projects and their potential social and environmental effects. These issues can be addressed through reinforced and enhanced control over the ESIA decision process and risk management approach by the independent authority.

92. **Climate Risks:** Ethiopia has experienced more frequent irregularities in climate patterns, including variability in rainfall frequencies and intensity and persistence of extremes like heavy rainfall causing floods in urban areas such as Addis Ababa and drought in several regions. Future climate variability and change are expected to worsen these conditions; potentially accelerating already high levels of land degradation, desertification, recurrent floods, as well as water scarcity. Recurrent drought and floods pose the greatest threat to Ethiopia. Due to Ethiopia's reliance on hydropower for a significant share of generation capacity, the short- and long-term sustainability of power supply and flooding risks to infrastructure will affect some results of this DPF series, particularly promotion of PPPs due to exposure to climate risks. Without appropriate planning these irregularities may increase the risks of fiscal instability and sustainability of PPP initiatives. In this DPF series, Prior Action 1 is creating/enabling the space for policy actions that can promote private sector investment in new climate smart technologies such as renewable energy and the promotion of climate resilient energy systems as well as in other sector specific infrastructure PPP projects. This would address/mitigate climate risks and can also generate adaptation co-benefits. While exposure to climate change impacts are currently moderate with potential high future exposure, policy actions that can support the implementation of Ethiopia's ambitious Climate Resilient Green Economy Strategy and GTP II can also help mitigate climate risk.

Risk Categories	Rating
1. Political and Governance	● High
2. Macroeconomic	● High
3. Sector Strategies and Policies	● Substantial
4. Technical Design of Project or Program	● Moderate

5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and Social	Substantial
8. Stakeholders	Substantial
9. Other	Moderate
Overall	Substantial

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions and Second Tranche Release Conditions under DPF1	Indicative Triggers under DPF2	Indicative Triggers under DPF3	Results Indicator
Pillar 1. Maximizing finance for development			
1.1 Promoting public-private partnerships			
Prior Action #1: Parliament has approved the PPP Proclamation and MoFEC has issued the PPP Directive to establish a regulatory framework and institutions that manage fiscal risks, enhance transparency, fairness and long-term sustainability in implementing privately financed projects.	*Indicative Trigger #1.1*: The PPP Directorate General issues PPP Implementation Guidelines with the required procedures and authorizations to undertake PPP transactions, including an assessment of the contingent liabilities related to the sovereign contractual obligations.	*Indicative Trigger #1.2*: The Government promulgates procedures and assigns independent authority to review, approve and enforce Environmental and Social Impact Assessments.	Starting January 2019, all PPP transactions are selected based on transparent and disclosed screening criteria and implemented according to the guidelines approved by PPP board: Baseline (2018): No Target (2021): Yes
1.2. Improving efficiency and restoring financial sustainability in the power sector			
Prior Action #2: The Recipient's Council of Ministers has approved a multi-year electricity tariff-increase framework with a detailed implementation schedule to improve cost recovery while protecting the poor.	*Indicative Trigger #2.1*: (i) The Government's Macroeconomic Committee has established a Power Sub-Sector Committee to oversee the development and implementation of an institutional reform roadmap in the power sector; (ii) The Ministry of Water, Irrigation and Electricity is implementing a performance improvement plan for improving operational performance in all business areas and with a focus on customer service, optimization of billing, improved collection rates, and loss reduction. (iii) Under the	*Indicative Trigger #2.2*: (i) The Government's Macroeconomic Committee has approved a reform roadmap for institutional reform in the power sector including recommendations for potential unbundling and privatization of selected power companies; (ii) Pursuant to the reform roadmap, EEU and EEP carry out the restructuring of EEU's and EEP's liabilities; (iii) Under the supervision of the EEA, the EEU and EEP carry out reform measures for a third year under the tariff framework.	Power sector has achieved full cost recovery: Baseline (2017): No Target (2021): Yes Institutional restructuring of the power sector completed in concordance with the Sector Reform Roadmap: Baseline (2018): No Target (2021): Yes Power sector losses (commercial and technical): Baseline (2017): 23% Target (2021): 15%

	supervision of the EEA, the EEU and EEP carry out reform measures for a second year under the tariff framework.		Power sector debt service coverage ratio: Baseline (2017): -1.84 Target (2021): +1.00
1.3 Introducing competition in logistics sector to reduce costs and improve efficiency			
***Prior Action* #3:** The Ethiopia Investment Board has lifted restrictions limiting logistics sector to domestic participation only, and permitted minority foreign investment in critical logistics services, including freight forwarding and shipping agency services, warehousing, cargo consolidation, and packaging to foster competition.	*Indicative Trigger #3.1*: The EIB permits: (a) the operation of fully foreign owned logistics providers in industrial parks and logistics clusters; and (b) the entry of foreign operators in the transportation sector through joint ventures with local logistics services providers.	*Indicative Trigger #3.2*: Ethiopia Revenue and Customs Authority: (i) launches the electronic single window system for regulatory procedures in trade clearance; and (ii) introduces a new customs management system.	Number of days to clear import by customs: Baseline (2018): 13.5 Target (2021): 10 Number of days to clear export by customs: Baseline (2018): 5.5 Target (2021): 4 FDI in logistics sector (cumulative): Baseline (2018): US$0 Target (2021): US$120 million
1.4 Introducing competition and foreign participation in the telecom sector to improve connectivity			
Second Tranche Release Condition #1: Council of Ministers approves the establishment and constitution of an independent regulator for the telecom sector.	*Indicative Trigger #4.1*: The Council of Ministers approves the separation of MCIT's telecom regulatory functions from its service delivery responsibilities.	*Indicative Trigger #4.2*: (i) The Government's Macroeconomic Committee appoints transactions advisers for telecom privatization and the issuance of additional telecom licenses; (ii) The independent telecom regulator drafts and adopts model license templates; (iii) The independent telecom regulator formulates and adopts regulations regarding information security.	Number of licensees operating in Ethiopian telecom sector: Baseline (2018): 1 Target (2021): 3 Price of 1GB of data per month as % of GDP per capita: Baseline (2018) 12.6%. Target (2021): 5% Usage of mobile money, share of Age 15+ population: Baseline (2017): 0.32% Target (2021): 5%

Pillar 2. Improving investment climate and developing financial sector			
2.1. Introducing business regulations conducive to private sector development			
***Prior Action* #4:** The Ministry of Trade has reduced the number of licensing categories by half and eliminated the requirement for annual competence certificates for at least seventy percent of trade-licensing categories, to reduce the regulatory burden and simplify business entry impacting over one million businesses.	*Indicative Trigger #5.1*: The Council of Ministers adopts and submits new proclamations on investment and competition to Parliament enabling foreign participation in a broader set of economic sectors and enhancing competition.	*Indicative Trigger #5.2*: The Council of Ministers adopts and submits a new commercial code to Parliament modernizing legal framework for private sector.	Foreign Direct Investment value: Baseline (2018) US$3.7 billion Target (2021) US$5 billion Share of newly registered businesses required to obtain certificates of competence Baseline: 100% Target: 10%
2.2 Taking actions to remove constraints to access to credit in private sector			
	Indicative Trigger #6.1: (i) NBE and MoFEC approve an action plan to implement recommendations from CBE's audit; (ii) NBE and MoFEC approve a comprehensive reform plan for the Development Bank of Ethiopia.	*Indicative Trigger #6.2*: (i) NBE and MoFEC implement policy reforms under an action plan for CBE; (ii) NBE and MoFEC implement first-year reform measures under the comprehensive reform plan for DBE.	To be determined after completion of the audit
2.3 Establishing the government bond market and foreign exchange market			
	Indicative Trigger #7.1: The Macroeconomic Committee: (a) endorses a market-based framework for issuing and trading government securities; and (b) implements first measures to introduce tradeable securities.	*Indicative Trigger #7.2*: The NBE implements measures to enable flexible adjustments in exchange rate targeting real exchange rate competitiveness.	Share of tradable market instruments in the Government's total borrowing requirement: Baseline (2018): 0 Target (2021): 10%

Pillar III. Enhancing transparency and accountability			
3.1. Promoting citizen engagement and social accountability			
Second Tranche Release Condition #2 The Council of Ministers has approved for submission to Parliament a draft CSO Proclamation to promote greater CSO and citizen participation in the development process.	*Indicative Trigger #8.1*: (i) The Council of Ministers approves regulations to implement the CSO Proclamation that promote greater CSO and citizen participation in the development process; (ii) The Council of Ministers submits a new Access to Information proclamation to Parliament to provide citizens with greater access to information and data held by government ministries and agencies in Ethiopia.	*Indicative Trigger #8.2*: (i) The Council of Ministers has approved regulations to implement new Access to Information Proclamation to provide citizens with greater access to information and data held by government ministries and agencies in Ethiopia.	All Ethiopian CSOs are eligible to engage in social accountability activities: Baseline (2018) 0 Target (2021) All
3.2 Improving SOE management, transparency and accountability			
Prior Action* #5:** The Council of Ministers has approved Guidelines for privatizing SOEs that establish the objectives and principles of the privatization process, clear institutional responsibilities for managing private participation in strategic SOEs, and transparency and accountability provisions. ***Second Tranche Release Condition #3: MOFEC has expanded the scope of its existing debt-reporting arrangements to (i) provide detailed coverage of domestic debt of state-owned enterprises including by instrument and debt holder on a quarterly basis and (ii) disclose an annual report on public debt including SOE debt consistent	*Indicative Trigger #9.1:* (i) The Council of Ministers submits to Parliament a SOE Proclamation reflecting international good practice on state ownership, level-playing field, governance structures and policies, financing, debt management, performance management, transparency and disclosure requirements.	*Indicative Trigger #9.2*: (i) The Council of Ministers issues a regulation authorizing the creation of ownership entity, such as a holding company with defined mandate, scope, structure, governance arrangements, and financing.	Number of SOEs that have published on their website timely annual audited financial statements prepared using IFRS: Baseline (2018): 1 Target (2021): 9

with good practice; both by January 2019.			

ANNEX 2: IMF RELATIONS ANNEX

The Federal Democratic Republic of Ethiopia—Assessment Letter for the World Bank
August 28, 2018

Recent Developments and Outlook

1. **Recent macroeconomic developments.** Ethiopia continues to experience strong output growth as the economy recovers from recent droughts and key infrastructure and FDI projects come online. Official data[1] indicate that GDP grew 10.9 percent in 2016/17,[2] and growth in 2017/18 is estimated to have slowed to 7½ percent, as public spending restraint, foreign exchange shortages, and political uncertainty dampened activity. Inflation, at 14 percent in July 2018, remains above the authorities' single-digit target, driven by rapid credit growth, passthrough of the October 2017 devaluation, civil unrest-related disruptions, and import shortages. The monetary policy stance was tightened after the devaluation, but all key interest rates remain negative in real terms, and broad money growth robust. The general government budget deficit, although contained, ratcheted up to 3.8 percent of GDP in 2017/18, as revenue continued to stagnate. Tax shortfalls were offset by investment cuts, although anti-poverty and social programs were largely protected. Privatization of the national tobacco company provided additional budgetary funding. Aggregate financial stability indicators point to a profitable banking sector partly reflecting, however, strong protection from competition.

2. **External imbalances.** The external current account deficit narrowed further to 6.7 percent of GDP in 2017/18 (compared to 8 percent in 2016/17) due to higher services export revenue and policy-driven public imports restraint, but external imbalances remain high. FDI fell, possibly owing to political uncertainty, and other financial inflows also declined, contributing to acute foreign exchange shortages. Reserves fell further to US$2.8 billion (1.6 months of imports) by June 2018—assessed to be below adequacy benchmarks. In July 2018 the NBE took a non-concessional US$1 billion deposit from the Abu Dhabi Development Fund, which temporarily alleviated foreign exchange shortages. The nominal exchange rate with the USD was largely held steady since the October devaluation, leading to real appreciation in recent months. The 2017 Debt Sustainability Analysis (DSA) assessed the risk of debt distress as high. Since then, the public debt-to-GDP ratio is estimated to have increased by over 4 percentage points to 62.5 percent (33.7 percent of GDP corresponding to external debt). Preliminary estimates suggest that the two debt sustainability indicators that breached their respective thresholds in the 2017 DSA (the net present value of debt and debt service, both relative to exports) remain materially above these thresholds.

[1] Historical GDP numbers reflect official data. GDP measurement suffers from still unresolved source data weaknesses as identified by STA TA.

[2] The fiscal year runs July-June.

3. **Outlook and risks.** Real GDP growth is likely to remain strong at 8½ percent in 2018/19, supported by lower political uncertainty, temporary easing of forex shortages, and manufacturing FDI inflows. Medium-term growth is projected at around 7 percent, based on current policies—not incorporating a potential acceleration of reforms by the new leadership. The 2018/19 federal budget is consistent with a 3½ percent general government deficit, assuming restrictive execution. The current account deficit is envisaged to narrow gradually conditional on continued restraint on public projects, fast-growing manufacturing exports, albeit from a low base, and a more flexible exchange rate. In the short term, downward risks dominate owing to policy risk, a possible deterioration of the global trade environment or growth in partner countries and tightening of financing conditions for developing countries. Debt sustainability would deteriorate if the export acceleration envisaged under the baseline fails to materialize. Medium-term risks are balanced since adopting now a more ambitious and faster reform agenda poses significant medium-term growth upside—via private sector development and FDI.

Macroeconomic and Structural Policies

4. **The policy juncture.** Past state-led investments in energy, logistics infrastructure, agricultural extension, health, and education have created conditions for the emergence of a vibrant private sector and a manufacturing exports take-off, already in train. However, this public investment-driven development has led to external imbalances and debt vulnerabilities. The attendant distortions—epitomized by severe foreign exchange scarcity, market barriers in key sectors, and weak tax revenue and associated public savings—are obstacles to private sector expansion. Thus, economic policy needs to shift the center of gravity to private sector and market development. In the short term, tight monetary and fiscal policies (including SOEs) are needed to reduce external imbalances and public financing requirements.

5. **Fiscal policy.** Fiscal consolidation should be resumed, by reining in spending in 2018/19 budget to bring the general government deficit below 3 percent of GDP, implementing revenue mobilization reforms, and further reprofiling SOEs' large public projects with high import and external borrowing content. Continued protection of social spending and civil service wages is appropriate to preserve inclusive growth and reform implementation capacity. Strategic privatizations, PPPs with appropriate public finance safeguards, and private concessions could support growth while raising additional government funding. Fiscal and SOE governance, transparency, and accountability need to be enhanced significantly. Improvements in medium-term budgetary planning and project assessment would lead to a better resource allocation.

6. **Monetary, financial, and exchange rate policies.** Broad money growth should be reined in by tightening credit to the public sector—including phasing out NBE budget financing. Introduction of a market for government securities with market-determined interest rates would permit a more effective policy transmission and would deepen financial

intermediation. Administered interest rates need raising to reflect current inflationary trends. Forestalling a widening of the birr overvaluation will primarily require a tight macroeconomic policy stance, but also a more flexible exchange rate policy. In the immediate future, exchange rate management should be aimed at reducing birr overvaluation and building reserve coverage.

7. **Other structural reforms.** Reforms are needed to make the business environment more attractive to private investment. Priorities include addressing onerous and arbitrary administration practices, improving infrastructure, and strengthening availability of financial services. The authorities' efforts to expand women's labor force participation have the potential to drastically enhance growth.

IMF Relations

8. **The 2017 Article IV consultation was concluded by the IMF's Executive Board on January 12, 2018.** The mission to conduct the 2018 Article IV Consultation is scheduled to take place in September. In recent years, IMF technical assistance has focused mainly on tax policy and administration, public financial management, central bank operations and financial supervision, and statistics.

ANNEX 3: LETTER OF DEVELOPMENT POLICY

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I.F.R.E 4/2/44
ቀን
Date 07 SEP 2018

Annex: Letter of Development Policy

September 7, 2018

Dr. Jim Yong Kim
President
World Bank Group

Federal Democratic Republic of Ethiopia
Support to Privatization and Reform Initiative
(2018 – 2020)
Letter of Development Policy

Dear President Kim,

Ethiopia has made substantial progress and transformational strides in the past fifteen years. Economic growth picked up and entered a new growth trajectory since 2004 averaging over 10 percent per annum since then. The accelerated economic growth was largely inclusive and translated into better development outcomes. Poverty, inequality and unemployment substantially declined, while access to essential social services expanded. Health outcomes improved as reflected in the decline of child mortality by 60%, and maternal mortality by 52% between 2000 and 2016. Life expectancy of citizens improved by more than 15 years since the year 2000, so much so that it has now exceeded those of LDCs and SSA averages.

The growth momentum that led to the above results has continued. The Ethiopian economy is set to be among the fastest growing economies in the world for the next three years. Economic growth in FY2016/17 was 10.9%, and this robust growth is expected to continue in FY2017/18, as evidenced by the performance of the agriculture sector, for which data is already available.

The last three years have seen however new phase of challenges related to democratization and popular participation in the overall governance of the country. Moreover, in spite of the impressive progress in economic growth and

ስልክ
251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲጽፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፑብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I/F.R.E4/2/4
ቀን
Date 07 SEP 2018

poverty and unemployment remain high, causing growing discontent particularly among the youth. In response to these emerging challenges, the ruling party nominated a new prime minister, Dr. Abiy Ahmed, in March 2018, thereby ushering a new era of change and transformation fitting for the coming years. The transition and the subsequent changes the country experienced signified the strengthening of institutions, and created renewed optimism among citizens and promising prospect about the future of the country.

One of the major areas of transformation announced by the new government, soon after assuming the leadership was its policy intentions to privatize partially and fully major state-owned enterprises (SOEs). This major policy announcement publicized on June 5, 2018 aimed at sustaining inclusive and rapid growth, as well as accelerating structural change. These announcements are coming on the back of the introduction of various new measures by the new Prime Minister, who from day one has taken actions to spearhead engagements with various stakeholders located within and outside the country. The engagements and reaching-out to various stakeholders were instrumental in the exchange of views between the population and the government about concerns of stakeholders as well as views of the government and the direction the country is planning to take in the coming years.

The Ethiopian government led by Prime Minister Dr. Abiy Ahmed, started a wave of reform actions through spearheading several consultations with various population groups and representatives of communities across the country to discuss about inter-community relations, sources of conflicts between different population groups and the future direction of the country. The discussions and conversations focused on broader themes such as peace and stability, respect and accommodation between/among population groups, rule of law, deepening democratization and shared vision for an inclusive, prosperous and transformed Ethiopia. The Prime Minister also held discussions with the business community, political parties, academia, and various civic society organizations. Ethiopia's prime minister also discussed with diaspora groups residing in northern America as part of his efforts to reaching-out to the broader public and various population groups which is expected

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. ፲·F·R·E 4/2/44
ቀን
Date 07 SEP 2018

to be instrumental in promoting peace, harmony and more collaborative work in the country. Moreover, as part of the government's commitment to deepen democracy and strengthen institutions, it introduced pardon and amnesty, and subsequently released prisoners and engaged opposition political parties including those operating from outside the country. These are expected to consolidate the democratization process, broadening the political space that sufficiently accommodates various views and opinions in shaping the future of the country. The government is now focusing on institutionalizing these measures to ensure sustainability of the gains.

Yet another significant development in the recent history of Ethiopia is the reengagement with Eritrea. The Ethiopian government under the leadership of Dr. Abiy took a bold initiative to normalize relations with Eritrea, which was positively accepted by the Eritrean government. Subsequently, the two countries exchanged visits headed by their leaders and a peace accord was signed by the two countries, thereby terminating the no-war-no-peace status which characterized the political climate between the two countries for the past 20 years. Direct air transport and telecommunications connections are reinstated. Multitudes of initiatives are currently underway to reengage the two countries on economic and social levels, so that the people of both countries can benefit from stronger integration. Broadly, the new Prime Minister reconfirmed his government's commitment to continue to become a stabilizing force and promote integration in the horn of Africa region by starting his first official visits overseas from the neighboring countries.

Going forward, the Ethiopian government will continue to prioritize structural economic transformation, accelerated and inclusive economic growth, development of the private sector, creation of more jobs both in rural and urban areas, and building resilience of the economy to climate and market risks. The economic growth strategy will pursue economic transformation that will sustain the economic growth. Poverty is still a major challenge for the country with millions living below the poverty line. For this reason, the government will ensure that inclusive development strategy supported by a sustainable safety nets system will anchor its transformational agenda.

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. ፲.F.R.E.4/2/44
ቀን
Date 07 SEP 2018

State Owned Enterprises (SOEs)Governance and Management Reform

One of the underlying strengths of Ethiopia's rapid economic growth over the past several years was the government's decision to prioritize investment in the allocation of public funding. For this purpose, in addition to the government budget instrument, the country reoriented state owned enterprises to finance critical infrastructure and renewable energy. These investments were instrumental in reducing the infrastructure deficit in the country, including through investments in renewable energy, telecom, railways, air transport, shipping and roads. These investments also served as crucial sources of accelerated and inclusive growth over the last two decades.

However, the performance and achievement of the various SOEs has been mixed. While there are cases of excellence in SOE governance and management, several cases of underperformance and poor management were also observed. For this reason, the Ethiopian government recently launched an SOE reform agenda. A diagnostic assessment on SOEs performance highlighted that risks and underperformance are caused by several factors, including (i) that objectives and regulatory structures are unclear, compromising transparency and leading to developmental and commercial underperformance, (ii) unclear reporting lines for SOEs with shareholding rights split across government, leading to poor shareholding management, (iii) delays in performance reporting and when reports are submitted coming with major qualifications and inadequacies (iv) little support or consequence for underperformance, and (v) board appointments lacking rigorous selection criteria to prioritize capabilities needed from the individuals appointed to the SOE boards.

To address the above challenges, the Ethiopian government has launched an SOE transformation agenda. The immediate actions launched under this agenda include: (i) establish an SOE Steering Committee and set up a high powered joint-working team that performance-manages the nine big priority SOEs; (ii) secure cabinet approval to publish overall SOE transformation roadmap, (iii) assess CEOs of nine priority SOEs and replace where necessary, (iii) prepare individual transformation

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. ፲·ፎ·RE4/2/44
ቀን
Date 07 SEP 2018

plans for each of the nine priority SOEs, and (iv) assess the board composition of the nine priority SOEs against selection criteria and make changes where necessary.

Privatization of State Owned Enterprises (SOEs)

In addition to the SOE governance and management reform, the government committed to undertake structural reforms including partial or full privatization of its SOEs with the overarching objective of advancing the country's growth and structural transformation while promoting private sector development. The recent government policy decision to privatize state-owned enterprises (partially and wholly), has as its primary objective to help sustain the robust economic growth the country witnessed for over a decade and half, and accelerate structural transformation of the economy. For this reason, the government intends to guide the privatization process in such a way that it will be supportive of the economic growth and transformation agenda set for the country. More specifically, the goals of the privatization drive are set as follows: (i) pursue a privatization program that will elevate the inclusive and robust economic growth of the last decades into a new phase, as well as accelerate structural economic transformation; (ii) support the country's transformation through leveraging additional development finance to be generated from the privatization of the SOEs; (iii) the promotion of private sector development through creation of additional business opportunities and signaling or confidence effect of these unprecedented privatization drive to the private sector; (iv) transform the SOEs themselves, through a roadmap that modernizes corporate governance, strengthens the regulatory environment, and structures the market; (v) enhance the viability and competitiveness of SOEs, so that through stronger creditworthiness they will be in a position to access both domestic and external financing on their own balance sheet. In this regard, while Ethiopia has emerged as one of the biggest investment destination on the African continent in the past few years, the recent policy announcement to privatize big and strategic SOEs is expected to further boost the country's image as an attractive destination for private capital.

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I/F/R/E 4/2/44
ቀን
Date 07 SEP 2018

The government will execute the privatization program with utmost transparency, accountability and integrity. A comprehensive policy and regulatory framework that support a competitive market structure and protection of public interest will be put in place to help deliver on the key goals of the privatization program. In case where the privatization program affects employment, a social program will be developed to assist employees affected by such.

The government has already taken concrete actions towards implementing the privatization policy pronouncements. It has development a guideline that outlines the governance arrangement for the privatization program. The governance arrangement was reviewed and approved by Council of Ministers on September 1/2018. Furthermore, the Ethiopian government has prepared a policy options paper for the opening up, market reform and privatization the telecom sector. The policy proposal and implementation modality proposed was approved by government's Macro Economic Committee, chaired by the Prime Minister, on August 29/2018.

Public Finance Management Strategy and Medium Term Fiscal Management

The Ethiopian government has committed to guide its public finances through its newly introduced Public Finance Management (PFM) Reform Strategy (2018-2021). One of the nine strategic goals of the PFM reform strategy commits the government to enhance revenue mobilization and pursue a prudent expenditure stance such that within a reasonable timeframe it balances its revenues and expenditures. In parallel, after putting in place required institutional arrangements, the country will ensure that the pricing of the government's domestic financing of its budget evolves to market determined rates.

Consistent with the country's fiscal policy, the government has continued to exert more effort to strengthen its domestic revenue mobilization, achieve more effective and efficient allocation and utilization of public resources as well as maintain fiscal deficit consistent with its macroeconomic objectives. This was even more pressing given the political challenges the country faced last three years. As a consequence,

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I·F·R·E·4/2/44
ቀን
Date 07 SEP 2018

the country's budget for the last two fiscal years grew only modestly compared to earlier years. Even then, the government was able to achieve a budget execution outturn which is very much close to the initial objectives with regard to budget deficit. Overall, such a cautious and tight fiscal control will continue in the medium term until revenue mobilization recovers to its earlier growth trajectory.

Main challenges on the revenue side remain to be administrative bottlenecks. For this reason, reform focus will continue in areas of strengthening core operational processes, improving organizational structures, better use of data and information technology, strengthened enforcement that support compliance, and enhanced human resource management. The government has undertaken an extensive assessment of its tax expenditures accorded to promote private investment, export and manufacturing. A system that helps monitor the structure and magnitude of the tax incentives will be establish, and subsequently an informed decision will be taken to streamline the tax expenditures. The government expects tax revenue collection, as well as transparency and accountability in taxation to improve over the coming years.

Regarding budget expenditure, the government has maintained tight control over recurrent expenditures, and this orientation will continue in the medium term, while ensuring running costs associated with service delivery at all levels will be adequately funded. Budget-financed infrastructure investment is another area where the government's active fiscal management is visible. Due to the below-plan revenue collection, the government initially acted to limit the financing it makes available for new capital projects. For instance, in new FY2018/19, the capital budget allocated is solely to complete ongoing projects. In the coming years, the government will assess its revenue mobilization trends and prospects, before making significant commitments in the form of capital budget allocation for new projects.

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲጽፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. ገ.ኢ.ት.ሚ.4/2/44
ቀን
Date 07 SEP 2018

Efficiency and effectiveness of public expenditures is another area of reform. As part of the medium term macroeconomic framework as well as annual budget exercise, a review of past expenditures and status of project implementation is regularly considered before further commitment to deploy new money is made. However, there is a recognition about the need to deepen such reviews and assessments. On the other hand, putting in place a comprehensive public investment management framework, in particular to guide decisions with regard to lumpy investments executed by SOEs is expected to add value due to the amount of resources involved in the SOEs domain. For the above reason, the government is developing a comprehensive public investment management framework, which is expected to improve efficiency in public resource allocation and utilization throughout the project cycle.

Debt Management

The Ethiopian government borrows to finance projects that helps to boost export and industrial manufacturing, build human capital and physical assets, reduce poverty and enhance social and infrastructure development. External loan policy of the government primarily focuses on concessional loans with long grace and maturity periods and very low interest rates.

Ethiopia's public sector debt is guided by a medium-term debt management strategy. The strategy defines how debt should evolve over the medium term in support of financing the country's medium term development program, while maintaining macroeconomic stability. Recognizing the impact of debt burden on future generation and responsibility of each citizen, every single loan is subjected to the approval and oversight of the Ethiopian House of People's Representatives (Parliament). To ensure transparency and accountability in debt management, each loan is publicized through the country's Negarit Gazette, as required by the Federal Government Financial Law and Regulations.

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I.F.R.E-4/2/44
ቀን
Date 07 SEP 2018

However, of recent years, the mismatch between the foreign currency denominated nature of the country's debt (both government and SOEs), and the weaker foreign currency generating performance of the economy has created imbalances. Decline in the growth of export earnings reduced foreign exchange availability to service debt. In recognition of the increased debt related risk posed on the country's public finances, the Ethiopian government has taken additional measures to tighten the pace and screening process for new commercial debt contracting. In 2017, the Ethiopian government has issued a new directive setting the procedure for new contracting as well as utilization of new borrowings. As a result, the origination and approval of new contracting has now been fully centralized under the Ministry of Finance and Economic Cooperation (MoFEC). In addition, MoFEC has established a Public Debt Management and Advisory Committee, which is tasked with the review and authorization of each and every new borrowing before any formal contract could be entered in to sign on loan agreements.

The Ethiopian government is thus committed to implement this intensified vigilance and screening of new loans until public debt related metrics of the economy comedown to acceptable levels. To ensure full transparency on new loan commitments and debt, MoFEC has committed to implement a quarterly reporting arrangement with the World Bank.

Public-Private Partnerships (PPP) and Infrastructure and Energy Financing

The government will continue with its restrained stance regarding the financing of new public infrastructure investments through its budget and SOEs financing. While the focus will be on the completion and operationalization of publicly funded projects currently under implementation, in parallel, the government will promote increased role for private sector participation in the provision of infrastructure and energy to help address its huge energy and infrastructure deficits, and thereby also sustain its growth and transformation agenda. In this regard, the recently enacted Public Private Partnership regulatory framework will be instrumental. A PPP Directorate is now operational within MoFEC and a high-powered PPP Board, which includes two private sector representatives has been appointed. In order to develop a successful PPP

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I.F.R.E.4/2/44
ቀን
Date 07 SEP 2018

program in the country, the government, through its PPP policy has selected the energy and transport sectors as priorities for PPP implementation, with further sectoral expansion to be considered at a later point, after lessons are learned from the current phase.

The PPP framework provides for a robust system of selecting appropriate projects to be developed under PPP modality as compared to traditional public procurement. The system requires not only value for money based assurance, but also puts a strong safeguard screening process where environmental and social considerations have to adequately assessed before signing off a project to be developed through a PPP. The process to develop sectoral guidelines has started which will specify the screening criterion for environmental and social considerations.

Due to the complexity of PPP projects, the Ethiopian government has started putting in place adequate capacity both at the PPP Directorate level and contracting authorities. The government plans to use adequate external expertize to support the government institutions involved in PPP projects processing, including transaction advisers. A key element of the screening and assessment of PPP projects will be their implication on public finance – through government support and contingent liability. As required by the PPP law, the Ethiopian government will ensure projects selected for implementation through the PPP modality will not impose significant contingent liabilities on the public sector.

External Sector, Export Performance, Competitiveness and Banking

A major driving factor for Ethiopia's sustained growth since 2004 was the robust growth in exports. The country's exports grew at more than 20% a year since 2002 thereby enabling the doubling of goods export earning every four years. While global prices were supportive of the surge in export growth, domestic production growth, in particular, from the agriculture sector was key to the expansion in export. This export surge was instrumental in the creation of jobs and foreign currency generation. But in addition to favorable global condition and volume expansion, the Ethiopian government's strategic intervention to develop some sectors contributed

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፑብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I.F.R.E.4/2/94
ቀን
Date 07 SEP 2018

to the positive performance in exports. Key in this regard is the revelation of the horticulture industry which was nurtured through well-designed government policies. Similarly, sound strategies anchored on long-term vision helped to expand air transport services export earnings.

In recent years however, imbalances in the external sector have become a major challenge for the country. The trade imbalance portion is mainly explained by the underperformance of the export sector in recent years. The other dimension emanates from increased burden from accumulated external debt contracted to finance major infrastructure projects and productive investments with the expectation that export earnings would continue to expand. Measures taken by the government, including policy measures which limited new public sector commercial borrowing, are arresting further deterioration in the external imbalance. The external current account deficit in 2017/18 has narrowed to 6.7 percent of GDP, compared to 8 percent in 2016/17. The decline in the deficit is seen to be noteworthy when put in the context of the ratio in 2015/16, which was elevated at 10.4 percent of GDP and 11.5 percent in 2014/15. Improved performance in export of services and policy-induced public imports restraint contributed to the recent reduced current account deficit.

Yet, commodity export will continue to pose challenges on the current account. Due to drop in global prices for export commodities since 2012, Ethiopia's export growth continues to experience major difficulties. Although some efforts to increase volume of exports compensated for the loss, overall export earnings declined as percentage of GDP for most of the last several years. The government recognizes that Ethiopia is vulnerable to price swings because unprocessed agricultural products dominate its exports. For this reason, the country has been working to diversify its exports, with increased focus on manufacturing and energy export. Renewed efforts in accelerating value addition is also part of the broader strategy.

In terms of the structural issues that are constraining export sector development, the reform agenda of the Ethiopian government includes the following: (i) promote and establish industrial parks as a base for manufacturing and quality job creation,

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. ገ.F.R.E.4/2/44
ቀን
Date 07 SEP 2018

(ii) increase value-addition and quality of export products, (iii) ease constraints related to the supply of reliable power, credit, and foreign exchange, (iv) address challenges related to trade logistics and transport, (v) improve the rules and regulations governing business operation in the country, and (vi) maintain a real exchange regime that supports the competitiveness of the country.

The Ethiopian government will continue to take measures that will improve the competitiveness of the private sector. The Ethiopian Airlines provides a competitive cargo transport and large cargo logistics facilities at its hub at Addis Ababa Bole International Airport, while the electrified railway line that connects the country to the seaport of Djibouti has now started commercial transport operation. Moreover, the completion and operationalization of more and more industrial parks will facilitate export-oriented economic transformation. As of July 2018, eight industrial parks have become operational, with monthly export performance exceeding 14 million USD and employment of more than 56 thousand people. As most of these parks are progressively trying to expand towards their capacity, over the medium term, the eight parks and several others under construction will contribute significantly to the foreign exchange generation and employment creation the country needs.

On a related front, to enable the delivery of integrated response to trade logistics challenges, the Ethiopian government in August 2018 approved a National Logistics Strategy. The strategy provides a framework for subsequent actions that will facilitate efficient import-export trade – including faster clearance of cargo from sea ports and dry ports; reduce excess cost and delays encountered by private and public operators in the process of using logistics facilities; to provide an improved legal basis for inter-sectoral coordination and modernized delivery of logistics services; and through introducing a clear vision about the future direction of logistics services in Ethiopia, enable stakeholder to design appropriate solution and modernization which leverages technology to provide competitive solutions.

Beyond the broader policy frameworks provided by the National Logistics Strategy, the Ethiopian government subsequently took concrete actions to address some key

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I.F.R.E.4/2/44
ቀን
Date 07 SEP 2018

regulatory constraints that prevented the participation of international private operators in the sector. Accordingly, in the spirit of promoting joint ventures between domestic operators and international players, the Board of the Ethiopian Investment Commission has amended the investment regulation in August 2018, to allow international private operators to participate in the provision of services including bonded warehouse, consolidation and deconsolidation services and allow joint venture participation of international logistics service providers holding up to 49% of stake.

Regarding banking industry in Ethiopia, the sector remains one of the drivers of growth in the country. It has played a key role in delivering the accelerated economic growth and expansion of investment in building productive capacity over the last two decades. However, the pace of financial sector development and modernization of banking falls short of matching the transformation agenda the country has embarked upon. The Ethiopian government recognizes that the economic transformation agenda has to be supported by modern and vibrant financial sector. Towards this end, the National Bank of Ethiopia (NBE) has initiated the preparation of a financial sector roadmap. The roadmap will layout Banking sector reforms, which will be aligned with Ethiopia's WTO accession agenda. Furthermore, the roadmap will address key issues including credit to the private sector and purchase of NBE bonds. During this process, NBE will also design and implement a market-based framework for issuing and trading government securities.

On the monetary policy side, the government is committed to take measures that improve the competitiveness of the exchange rate. The National Bank of Ethiopia will continue to undertake additional measures to usher-in modern foreign exchange management and enhanced availability of foreign currency to the private sector to encourage investment and exports. In August 2018, the Board of the National Bank of Ethiopia (NBE) passed decisions on four action areas which are expected to contribute towards easing some of the restrictive provisions related to foreign exchange and credit availability to the private sector. These are just initial steps, and they will be supplemented through other measures based on objective assessments.

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. I.F.R.E.4/2/44
ቀን
Date 07 SEP 2018

Electricity Tariff Adjustment

Another important structural reform that supports sustained growth and transformation concerns electricity tariff reform. Ethiopia is currently one of a few countries globally which produces more than 95% of its electricity from renewable sources, including water, wind, solar, and geothermal. Due to a strategic prioritization of the energy sector in the country's development plan, Ethiopia was able to expand its energy production capacity by ten-fold in the past 25 years, albeit from a low-base. This same period has coincided with rapid growth in demand for electric energy, which continues to grow at more than 20% per year.

On the other hand, several years have passed since electricity tariff adjustment was made. During this time, cost of providing electricity has been rising due to several factors. For this reason, the Ethiopian government undertook a comprehensive electricity tariff study, which recommended cost-reflective tariff adjustment. In addition to improved cost recovery, the multi-year electricity tariff reform will encourage private investment in the generation of renewable electricity for domestic supply and exporting.

In August 2018, the Ethiopian government adopted a new tariff adjustment. The adjustment considers various consumer categories and designed tariff structures. The new tariff structure and rate takes into consideration social aspects, whereby consumers with low consumption are subsidized from rates applied to high volume consumers.

Transparency and Accountability

Budget transparency was one of the areas where the Ethiopian government has implemented various reform actions to enhance citizen participation in the budgetary process. As a result, financial transparency and accountability has now become a mainstream aspect of the public finance landscape in Ethiopia. To further deepen the reform, the government will introduce measures that enable to disclose budget execution reports on a regular basis through official websites. It has also

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲፅፉልን የኛን ቁጥር ይጥቀሱ

በኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ
የገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር
The Federal Democratic Republic of Ethiopia
Ministry of Finance and Economic Cooperation

ቁጥር
Ref.No. T.F.R.E. 4/2/44
ቀን
Date 07 SEP 2018

committed to a new set of transparency initiative concerning state-owned enterprises. Accordingly, the Ethiopian government will take measures that enable the major SOEs to disclose and publish their audited financial accounts regularly through official websites.

The role of civil society organizations in supporting the transparency and accountability of the public sector is another area of reform the government will promote in the next few years. For this reason, the existing civil society law will be revised, by taking into account the views and opinions of stakeholders and the wider populace, through extensive consultations. Currently, consultation is going on the draft amendment and in few weeks' time the revised law will be presented to the Council of Minister and the Parliament for approval and ratification.

Another areas of reform already initiated by the government is related to the country's media law. Here again, after considering issues and constraints that were raised in the past several years, the Attorney General Office has drafted a revised media law. Currently, the draft law is being discussed by the broader public. In few weeks' time, the proposed amendment will be presented to the Council of Ministers and subsequently to the Parliament for approval and ratification.

As a final note, the objective of the above set of extensive reforms and many others not mentioned here is to sustain the rapid and inclusive economic growth the country witnessed over the past decade while laying the ground for economic transformation that leverages the increasing role of the private sector.

The Federal Democratic Republic of Ethiopia * Ministry of Finance and Economic Cooperation

Sincerely

Abraham Tekeste (PhD)
Minister

ስልክ
Tel 251-11-155 24 00, 22 66 98
251-11-155 00 81, 83 86 89
የፖ.ሣ.ቁ
P.O.Box 1905,1037
ፋክስ
Fax 251-11-156 01 24,55 14 96
251-11-155 11 38
አዲስ አበባ ኢትዮጵያ
Addis Ababa- Ethiopia
እባክዎን መልስ ሲጽፉልን የኛን ቁጥር ይጥቀሱ

ANNEX 4: POVERTY AND SOCIAL IMPACT ANALYSIS

1. **Overall, the proposed DPF supports policy and institutional changes that are likely to have poverty-reducing effects in the medium term, though there will also be distributional impacts that should be addressed.** Although the operation is expected to have an overall positive impact on poverty reduction in the medium term, there may be some adverse effects in the short term. This is particularly true of the policy reform of electricity subsidies, which is expected to have the largest direct impact of all the proposed changes. The implications of the proposed tax policy reform are also likely to have some potentially significant poverty and distributional implications.

2. **The electricity tariff prior action is expected to have direct poverty and distributional impacts, while the other proposed policy changes under the three pillars may also have indirect impacts in the medium term.** Improvements in the business and private sector environment through PPP and SOE reform, and through addressing some of the key constraints to business operations are expected to lead a higher level of foreign investment, and the establishment of new enterprises in the country. This should help to create additional jobs which will go some way to helping to absorb the more than one million young Ethiopians who enter the labor force each year.

3. **Adjusting the tariff structure of electricity will increase available fiscal space and improve the welfare of Ethiopians in the medium-to-long-run, but it will have some negative impacts across the distribution of welfare in the short-run.** The current structure of tariff subsidies is regressive, meaning that the benefits are more heavily skewed towards the rich than they are towards the poor. This is in contrast to most other government expenditure. The proposed adjustment of tariffs will see price increases that are relatively larger for high users than they are for low users. For a given low price elasticity of demand for electricity, this will allow the electricity provider to become more financially sustainable, and to use additional revenue to expand and improve access.

4. **Currently, just over 10 percent of the poor population in Ethiopia has access to electricity.** The proposed tariff reforms should create the fiscal space necessary to expand access and improve service. This is particularly necessary given that tariffs have been nominally constant over the last decade. Another important priority should be to lessen the stark access to electricity gap that exists between rural and urban areas. Crowding in the private sector should help to meet the rapid growth in demand for electricity more efficiently, but needs to be complemented by addressing these access and reliability challenges in the country.

5. **The direct impacts of the electricity tariff reforms on households can be simulated by combining the proposed tariff structure with existing household survey data.** The Household Consumption and Expenditure Survey (HCES) from 2015/16 is used in conjunction with the Welfare Monitoring Survey as the basis for simulating the impact of changing tariff structures on household welfare. The Multi-Tier Framework for Measuring Energy Access (MTF) dataset from 2018 is used to refine some of the

assumptions that are made in the modeling regarding access, sharing of an electricity source, and monthly service charges.

6. **The proposed change in the pricing structure will see a move from Increasing Block Tariffs (IBT) to Volume Differentiated Tariffs (VDT).** Table 4-1 and Figure 4-1 present the existing tariffs alongside the proposed final tariff structure, as it will stand after two iterations of tariff increases. Moving from an IBT towards a VDT structure means that heavily-using consumers will no longer be subsidized implicitly. Under the IBT structure, all consumers were benefiting from subsidies – for example a consumer in block 4 (201 to 300 kWh) would receive the cumulative subsidies of the first three blocks in addition to the block 4 subsidy. Under the VDT system, extremely low-income consumers (corresponding to those who are consuming in block 1) will not have any reduction in their subsidy level. Heavy users, however, will see sharp reductions in subsidies. Users in block 4 will pay the assumed cost of production of ETB 2.182 per kWh, while those consuming in blocks 5, 6 and 7 will pay above the cost of production so as to cross-subsidize those in blocks 1, 2 and 3.[21]

Table 4-1 Existing and proposed final electricity tariff structures for residential consumers

(in ETB)

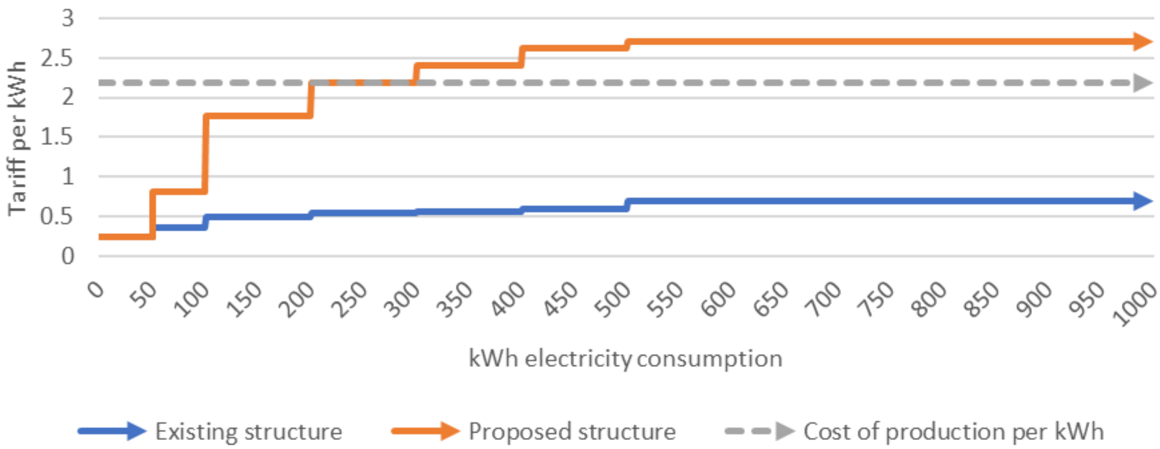
<table>
<tr><th rowspan="2"></th><th colspan="7">Consumption range (kWh)</th></tr>
<tr><th>0-50</th><th>51-100</th><th>101-200</th><th>201-300</th><th>301-400</th><th>401-500</th><th>> 500</th></tr>
<tr><td>Existing tariff</td><td>0.273</td><td>0.356</td><td>0.499</td><td>0.550</td><td>0.567</td><td>0.588</td><td>0.694</td></tr>
<tr><td rowspan="7">Proposed final tariff</td><td>0.273</td><td colspan="6"></td></tr>
<tr><td colspan="2">0.813</td><td colspan="5"></td></tr>
<tr><td colspan="3">1.761</td><td colspan="4"></td></tr>
<tr><td colspan="4">2.182</td><td colspan="3"></td></tr>
<tr><td colspan="5">2.404</td><td colspan="2"></td></tr>
<tr><td colspan="6">2.632</td><td></td></tr>
<tr><td colspan="7">2.717</td></tr>
</table>

Source: Ethiopian Electric Power (EEP) and Ethiopian Electric Utility (EEU), 2018.

Note: Prices are in ETB, and the proposed final tariff structure represents the structure after the full two-year tariff reforms have been completed.

[21] Under the final tariff structure there will be no change to block 1 pricing, and so the subsidy level remains the same. 75 percent of the cost increase for the second block will be subsidized, and 25 percent of the cost increase for the third block will be subsidized. The fourth block will be charged at the cost of service. The fifth, sixth and seventh blocks will subsidize 10 percent, 15 percent, and 75 percent of the total required subsidy amount, respectively.

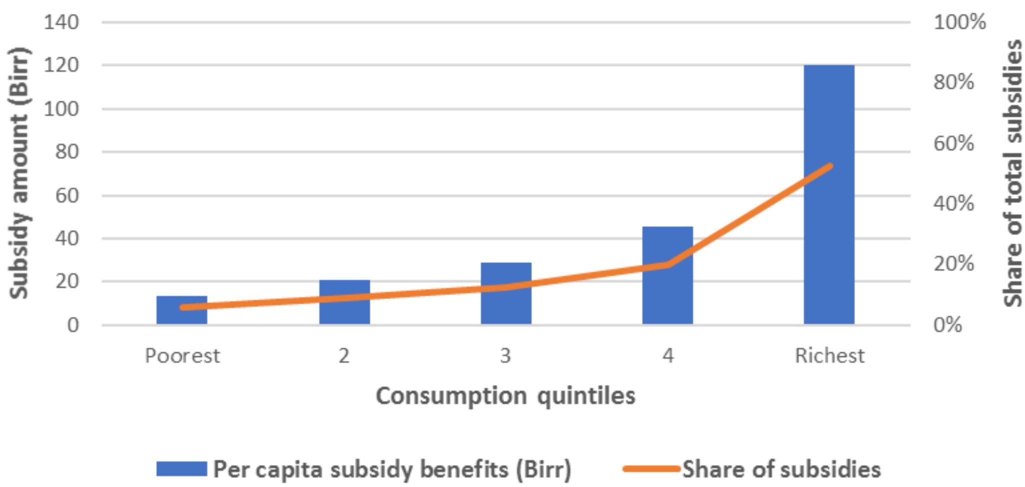
Figure 4-1 Existing and proposed final electricity tariff structures for residential consumers
(in ETB)



Source: Ethiopian Electric Power (EEP) and Ethiopian Electric Utility (EEU), 2018.
Note: Prices are in ETB, and the proposed final tariff structure represents the structure after the full two-year tariff reforms have been completed.

7. **The current IBT pricing structure has resulted in subsidies that are heavily skewed towards the top end of the distribution of consumption.** The average per capita subsidy benefit under the existing tariff structure is around ETB 13 for the poorest quintile. This rises to ETB 46 for the fourth (second richest) quintile, and is over ETB 121 per capita per month for the richest quintile. Unsurprisingly, given that access rates are far higher amongst the relatively well off, the total share of subsidies is skewed towards the richest quintile as well. Over 52 percent of the total amount that is subsidized accrues to the top quintile. The shares accruing to the first and second quintiles are 6 percent and 9 percent, respectively.

Figure 4- 2 Per capita subsidy amounts and share of total subsidies by quintile under current pricing structure



Source: World Bank calculations using data from the EEP, EEU and HCES 2015/16.

8. **The impact of the new proposed tariff structure will affect the richest quintile almost ten times more in monetary terms than the poorest quintile, but the effect is more muted when viewed as changes in the share of overall consumption.** Table 4-2 presents some results from a simulation of the welfare impacts of the electricity price subsidy reform.[22] The new tariff structure will reduce the spending power of the poorest quintile by just under ETB 18 per person per month. In contrast, the reduction in consumption for the richest quintile is almost ETB 160 per month – about nine times as large. Average consumption in the top quintile is not nine times as large as average consumption in the bottom quintile, and so the welfare-reducing effect in percentage terms is higher at the top than at the bottom. The reduction in welfare for the top quintile is about 5.4 percent, while for the bottom two quintiles it is around 3 percent.

Table 4-2 Impact of new tariff structure on monthly per capita well-being

3	**In ETB**	**In %**
Poorest 20%	-17.58	-3.18
2nd quintile	-27.20	-2.98
3rd quintile	-37.94	-3.19
4th quintile	-59.64	-3.95
Richest 20%	-157.22	-5.36

Source: World Bank calculations using data from the EEP, EEU and HCES 2015/16.
Note: ETB are expressed in real 2019 terms, with price adjustments made from World Bank forecasts of national CPI.

9. **Female-headed households tend to be smaller than male-headed households, and have higher overall consumption expenditure per capita.** Female-headed households also have higher per capita expenditure on electricity, conditional on access, which means that they both benefit more from the current subsidies, and will experience a relatively higher drop in consumption following the tariff reforms. Additional simulations that stratify by the sex of the household head show that not only do female-headed households tend to spend more on electricity per capita than male-headed households, they also have a higher share of total household expenditure that goes towards electricity. As such, the per capita benefits under the existing pricing structure are generally higher for female-headed households. The proposed change in the tariff structure is likely to have a disproportionately negative effect on female-headed households – a per capita reduction of well-being of about ETB 93, compared to a reduction of about ETB 52 for male-headed households.

10. **A revised and streamlined tax policy along with improved resource mobilization should allow the Government to contribute more significantly towards the GTP II.** This will bolster the Plan's progress towards broad-based and inclusive economic growth. Ethiopia is facing the fundamental challenge of trying to stimulate pro-poor revenue generation in a low-income setting. Taxes are generally progressive,

[22] There are several assumptions that lie behind these calculations. These include projections about inflation and population growth, along with meter sharing between households, spatial deflation across the country, and the assumed price elasticity of demand of zero. In addition, the results show the result of a move to the final set of proposed tariffs, though the current proposal is to adjust tariffs in equal increments over two years. Finally, the results only present the simulated impact of direct effects, and do not consider the indirect effects that increases in the price of electricity will have on other goods and services in the economy.

and fund much of the amount that is directly transferred to poor households, for example through the PSNP. However, there are some negative direct and indirect impacts on the poor from tax payments (World Bank, 2015). The proposed tax reform could directly benefit poor households in two ways. First, it could lower the incidence of direct taxation currently being levied on the bottom quintile. This is particularly true of personal income tax and agricultural tax. Second, additional tax revenue could be directed towards more extensive transfers to the poor, and to improving service delivery and access.

11. **Under the Second Pillar of enhancing competitiveness, there are potentially indirect poverty-reducing effects that may arise from improving telecommunication services.** An underdeveloped ICT sector has been flagged as one of the constraints to firm and job growth in Ethiopia (World Bank, 2016). Improving the regulatory environment while allowing for greater competition and increasing private sector participation in the sector can be expected to improve service delivery for households and businesses. Addressing the current inefficiencies, as proposed in the DPF, should ensure that there is progress towards growth and job creation that is led by the private sector. Enhancing the competitiveness of the sector will have medium-run impacts on poverty and inequality through the channels of prices, wages of the employed, and job creation.

12. **Improving access to finance and streamlining the operation of state-owned banks will increase the opportunities for households to access credit markets.** The World Bank's Enterprise Surveys show that the predominant constraint on Ethiopian businesses is a lack of access to credit and foreign exchange. Although the proposed reforms in this area are primarily focused on businesses, there is likely to be a pass-through to job creation. In addition, increasing household-level access to credit will better allow the vulnerable to smooth consumption, particularly in response to shocks. The upcoming Poverty Assessment for Ethiopia finds that having access to a bank or microlender in a community is associated with a higher probability of a household exiting poverty. This is in line with a substantial body of literature that has found that financial development disproportionately benefits those who are initially poor, and is associated with a reduction in inequality over time.

ANNEX 5: DEBT SUSTAINABILITY ANALYSIS

1. **The last DSA for Ethiopia was conducted jointly by the IMF and the WBG in 2017 as part of the IMF's Article IV consultation mission that took place from September 13-26, 2017.** The 2017 DSA downgraded Ethiopia's risk of external debt distress from "moderate" in the 2016 DSA to "high". The lukewarm export performance coupled with the maturing of the NCB contracted in the last five years led to a deterioration of the 2017 DSA indicators. As was the case in 2016, the threshold for the net present value of external debt-to-exports (PVDE) continued to be breached. New in the 2017 DSA was the breach of the debt-service-to-exports (DSE) indicator.

2. **In the baseline, the stock of external public and publicly guaranteed debt remains relatively stable through FY20, then declining gradually thereafter.** Of the two stock indicators, the present value of external debt-to GDP (PVDY) remains well below its threshold (40 percent) throughout the projection period. On the other hand, the present value (PV) of debt-to-exports (PVDE) exhibits large and persistent breaches of its threshold. The threshold breach observed for the PVDE is greatest in FY18 (102 percentage points above the threshold) and will not fall below the threshold until FY23 (six years).

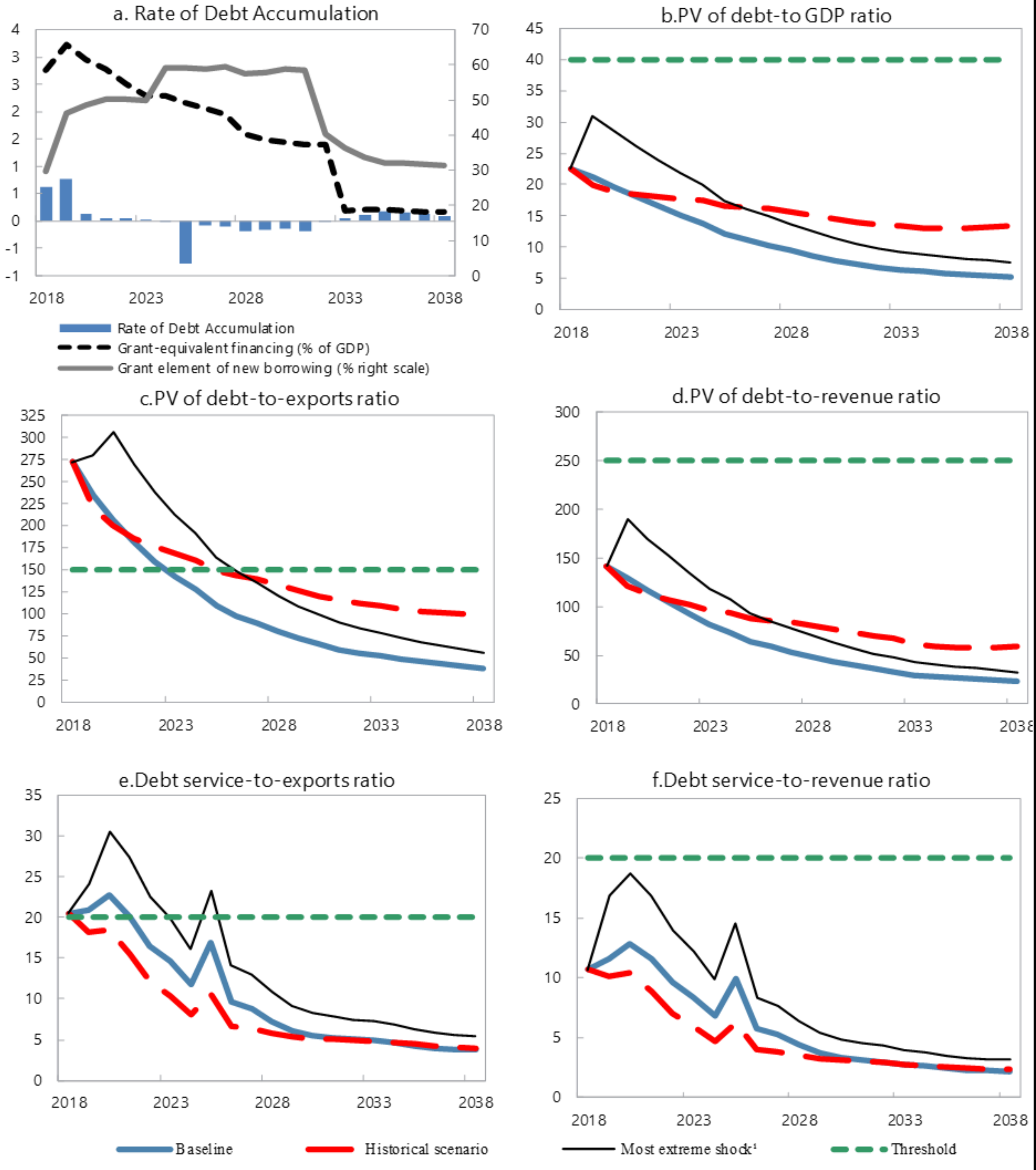
3. **Of the debt service indicators, the DSE ratio shows breaches of its thresholds.** The DSE exceeds its threshold in FY18 and peaks in FY20 (22.7 percent) before declining to below the threshold in FY22. The debt service-to-revenue (DSR) also breaches its threshold, although by a small margin (0.2 percentage point) and for just one year (2019/20). The DSR ratio, however, remains below the threshold for the entire projection period.

4. **From the stress tests, a shock to exports and an exchange rate depreciation shock produce the most extreme scenarios**. A shock to GDP growth doesn't significantly alter the baseline results for all four indicators. A one standard-deviation decline in GDP growth from its historical average or from the baseline (whichever is lower) in the second and third years of the projection period slightly raises the PVDY and DSR from their baseline levels but doesn't significantly alter the trend with respect to the threshold for all four indicators.

5. **Export shock significantly affects the PVDE and DSE.** If growth in exports declines by one standard deviation from its historical level or from the baseline (whichever is lower) in the second and third years of the projection period, the PVDE indicator will be breached for 8 years while the breach for the DSE indicator will be for 5 years. The PVDY and DSR indicators are not significantly affected by an export shock.

6. **A one-time 30 percent depreciation in the nominal exchange rate of the ETB in the first year of the projection period significantly affects the PVDY and DSR ratios.** However, both ratios remain below the threshold for the entire projection period under this scenario although the ratios will be significantly higher than in the baseline.

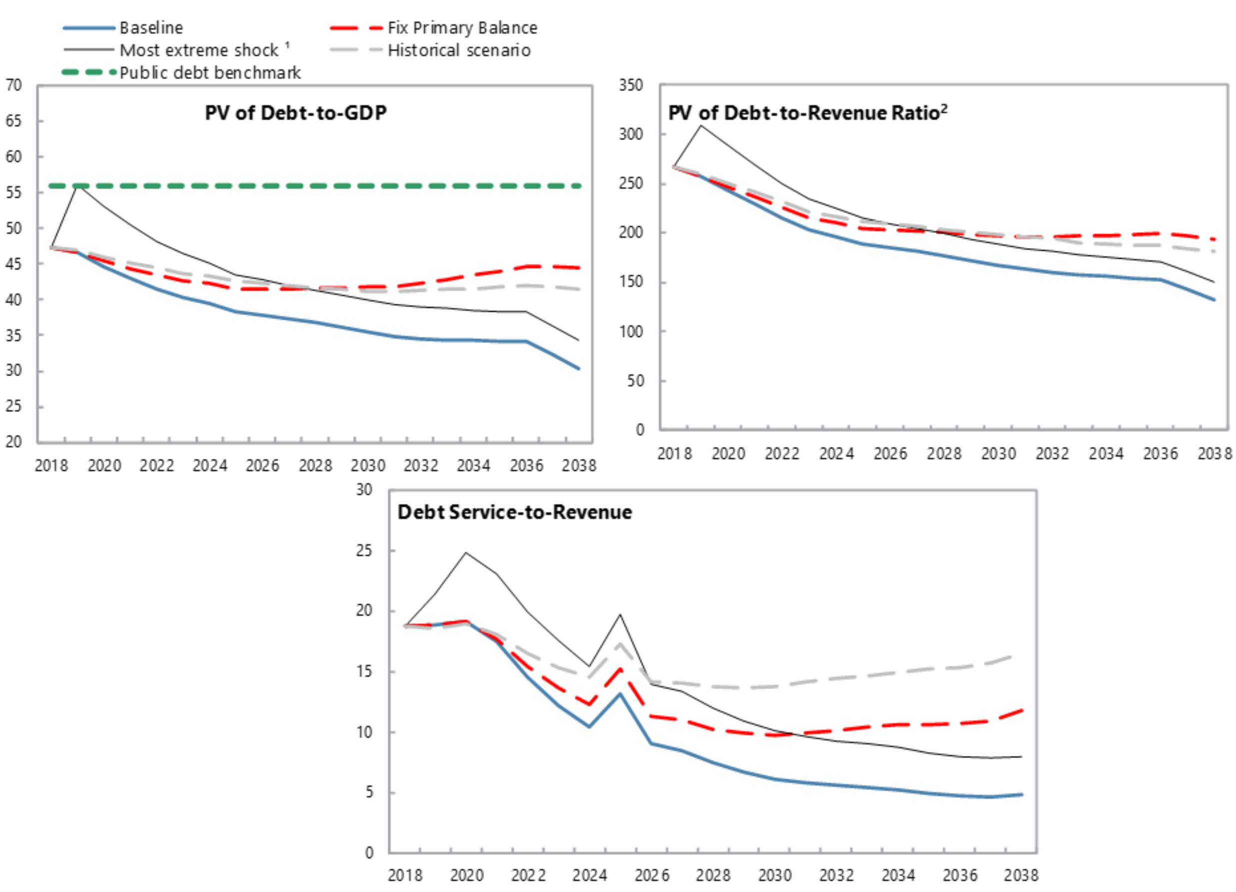
Fig. 5.1: Ethiopia External Debt Sustainability Analysis



Sources: Ethiopian authorities and staff estimates and projections.
[1] The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a One-time depreciation shock; in c. to an Exports shock; in d. to a One-time depreciation shock; in e. to an Exports shock and in figure f. to a One-time depreciation shock.

7. **Overall public debt does not flag additional risks (see Fig. 5.2).** The present value of total public debt stays well below the indicative threshold of 56 percent of GDP in the baseline and under most scenarios considered throughout the projection period. The only alternative scenario where a breach occurs is under the assumption of a primary fiscal balance throughout the simulation horizon fixed at its FY18 level. However, the baseline assumes a gradual increase in domestic interest rates to achieve positive real interest rates by the end of the DSA projection window. As a result, the primary balance in the baseline increases gradually over time, as fiscal policy accommodates the increased financing costs. In contrast, the fixed primary balance scenario implies a gradual widening of the fiscal deficit, contrary to the authorities' policy intentions and past record of prudent budgetary policy. All indicators also show a declining trend after FY26 as public investment tapers off with the completion of the large projects planned under the GTP II, and with it, the need for new borrowing slows as well.

Fig. 5.2: Ethiopia Public Debt Sustainability Analysis



Sources: Ethiopian authorities; and staff estimates and projections.
[1] The most extreme stress test is the test that yields the highest ratio on or before 2025. It corresponds to a one-time depreciation shock.
[2] Revenues are defined inclusive of grants.

8. **Increased borrowing in FY18 likely points to a weakening of debt sustainability since the 2017 DSA.** Total public and publicly guaranteed debt rose to 60.6 percent of GDP from 57 percent in FY17 (see Table 5.1). External borrowing was the major driver for this resulting in an almost 3 percentage point of

GDP increase in the stock of external debt. The US$1 billion deposit at the NBE by the Abu Dhabi Development Fund in July 2019 further increases the stock of external public debt. All these developments are likely to lead to a deterioration of the debt sustainability indicators and hence Ethiopia's risk of debt distress is likely to remain high.

Table 5.1: Ethiopia Composition of Public and Publicly Guaranteed Debt

	FY 17			FY 18		
	Billions of ETB	% of Total	% of GDP	Billions of ETB	% of Total	% of GDP
Total Debt	**1,027.2**	**100.0**	**56.9**	**1,304.8**	**100.0**	**60.6**
External	**525.7**	**51.2**	**29.1**	**689.3**	**52.8**	**32.0**
Domestic	**501.5**	**48.8**	**27.8**	**615.5**	**47.2**	**28.6**
Central government	238.5	23.2	13.2	300.6	23.0	14.0
Banks	*178.4*	*17.4*	*9.9*	*219.6*	*16.8*	*10.2*
NBE	*135.6*	*13.2*	*7.5*	*160.1*	*12.3*	*7.4*
Other banks	*42.8*	*4.2*	*2.4*	*59.5*	*4.6*	*2.8*
Non-banks	*60.1*	*5.9*	*3.3*	*81.0*	*6.2*	*3.8*
SOEs	263.0	25.6	14.6	314.9	24.1	14.6

Source: MoFEC, 2018.

ANNEX 6: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1: Maximizing finance for development		
Prior Action #1: Parliament has approved the PPP Proclamation and MoFEC has issued the PPP Directive to establish a regulatory framework and institutions that manage fiscal risks, enhance transparency, fairness and long-term sustainability in implementing privately financed projects	Yes - negative	Yes – both positive and negative
Prior Action #2: The Council of Ministers has approved a multi-year electricity tariff-increase framework with a detailed implementation schedule to improve cost recovery while protecting the poor	Yes - positive	Yes - negative
Prior Action #3: The Ethiopia Investment Board has lifted restrictions limiting logistics sector to domestic participation only, and permitted minority foreign investment in critical logistics services, including freight forwarding and shipping agency services, warehousing, cargo consolidation, and packaging to foster competition.	No	Yes – both positive and negative
Second Tranche Release Condition #1: The Council of Ministers approves the establishment and constitution of an independent regulator for the telecom sector	No	Yes - positive
Pillar 2: Improving the investment climate and developing the financial sector		
Prior Action #4: The Ministry of Trade has reduced the number of licensing categories by half and eliminated the requirement for annual competence certificates for at least seventy percent of trade-licensing categories, to reduce regulatory burden and simplify business entry impacting over one million of businesses	No	Yes – both positive and negative
Pillar 3: Enhancing transparency and accountability		
Second Tranche Release Condition # 2: The Council of Ministers has approved for submission to Parliament a draft CSO Proclamation to promote greater CSO and citizen participation in the development process.	No	Yes - positive
Prior Action #5: The Council of Ministers has approved Guidelines for privatizing SOEs that establish the objectives and principles of the privatization process, clear institutional responsibilities for managing private participation in strategic SOEs, and transparency and accountability provisions	No	Yes - negative
Second Tranche Release Condition # 3: MOFEC has expanded the scope of its existing debt-reporting arrangements to (i) provide detailed coverage of domestic debt of state-owned enterprises including by instrument and debt holder on a quarterly basis and (ii) disclose an annual report on public debt including SOE debt consistent with good practice; both by January 2019.	No	No