

Ethiopia Economic Update 7

SPECIAL TOPIC: Poverty & Household Welfare in Ethiopia, 2011-16



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Acknowledgements

The macro section of this Ethiopia Economic Update was prepared by Nora Dihel, Zerihun Getachew Kelbore, and Samuel Mulugeta. The special topic of this Ethiopia Economic Update was prepared by a team consisting of Tom Bundervoet, Berhe Beyene, and Arden Finn. The report was prepared under the general guidance of Mathew Verghis, Pierella Paci, Nataliya Mylenko, and Carolyn Turk. Comments were received from Jean-Pierre Chauffour. Special thanks go out to Manex Bule Yonis and Asmelash Haile Tsegay for invaluable advice and assistance on data processing and GIS mapping. The team is thankful to Ethiopia's Central Statistics Agency for making available the data upon which this report is based.

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Abbreviations and Acronyms

CAB	current account balance
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
ECX	Ethiopian Commodity Exchange
ESS	Ethiopia Socioeconomic Survey
FDI	foreign direct investment
FDRE	Federal Democratic Republic of Ethiopia
FEWS NET	Famine Early Warning System Network
FY	fiscal year
G&S	goods and services
GDP	gross domestic product
GERD	Grand Ethiopian Renaissance Dam
HCES	Household Consumption Expenditure Survey
HH	households
IMF	International Monetary Fund
kcal	kilocalories
MOFEC	Ministry of Finance and Economic Cooperation
MOFED	Ministry of Finance and Economic Development
NBE	National Bank of Ethiopia
NPC	National Planning Commission
PPP	purchasing power parity
REER	real effective exchange rate
RHS	right-hand side
SNNPR	State of Southern Nations, Nationalities, and Peoples' Region
SOEs	State-owned enterprises
UN DESA	United Nations Department of Economic and Social Affairs
VCI	Vegetation Condition Index
WEO	World Economic Outlook
WTO	World Trade Organization



Executive Summary

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Recent Economic Developments

Ethiopia's real gross domestic product (GDP) growth, while still strong, decelerated to 7.7 percent in FY2018. A slowdown in industrial growth, mainly driven by lower growth in construction due to foreign exchange shortages and higher prices of imported construction materials, coupled with weaker performance of the manufacturing and the agriculture sectors, explains to a large extent the growth deceleration.

Services sector exhibited strong growth in FY2018 while manufacturing underperformed. In addition to the prevailing structural- and trade logistics-related challenges, severe foreign exchange shortages and political unrest affected the manufacturing sector over the past three years, with the magnitude of the effect peaking in FY2018. As a result, manufacturing growth has dropped drastically, from 24.7 percent in FY2017 to 5.5 percent in FY2018.¹ Large and small-scale industries underperformed dramatically. By contrast, growth of services increased from 7.5 percent in FY2017 to 8.8 percent in FY2018, with real GDP growth driven mainly by services (3.4 percent). Agricultural growth decelerated from 6.7 percent in FY2017 to 3.5 percent in FY2018, mainly due to slower growth of crop production. On the demand side, government and private consumption declined by about 1 percentage point each.

¹ The drastic fall in growth may also be explained by measurement issues. See box 1.1, in part one, for details on inconsistencies in GDP estimates in the System of National Accounts.

Inflation declined in the first half of FY2019 after surging to double digits in FY2018.

Since peaking at 16.8 percent in June 2018, due to the expansion of public sector credit in 2017, broad money growth, pass-through of the October 2017 devaluation, and political disruptions (which adversely affected distribution networks), inflation has been on a declining trend. It reached a low of 10.4 percent in December 2018. The price deceleration has been more rapid for food products, which decreased from 17.8 percent in June 2018 to 11.4 percent in December 2018, than nonfood items, whose prices decreased only marginally (from 11.1 to 9.1 percent during the period). There was a slight uptick in inflation to 10.8 percent in January 2019.

The National Bank of Ethiopia (NBE) has resumed its policy of gradual depreciation of the birr against the U.S. dollar in FY2019, after keeping the exchange rate largely constant in FY2018 following the October 2017 devaluation.

Following the 15 percent one-off devaluation in October 2017, the nominal exchange rate was kept largely constant for the remaining period of FY2018. The official exchange rate against the U.S. dollar depreciated by less than 1 percent between October 2017 and June 2018. The NBE allowed the birr to depreciate by about 2.9 percent against the U.S. dollar during the first six months of FY2019. The premium between the official and parallel market exchange rates widened in FY2018, reaching a peak of about 30 percent toward the end of the fiscal year. However, there was a sharp narrowing of the premium in June/July (reaching about 5 percent), following the government's call for the public to exchange foreign currency holdings in commercial banks. The premium has again started to widen in recent months, returning to its previous level of about 30 percent. The real effective exchange rate (REER) depreciated by 7.1 percent in FY2018, reversing the appreciating trends of the past six years, mostly aided by the devaluation. However, the depreciating trend has

reversed in recent months, with the REER showing a quarter-on-quarter appreciation of 4.8 percent in the first quarter of FY2019, as the inflation differential with trading partners remains high.

The government continued to adhere to a cautious fiscal policy stance in FY2018.

According to the latest official data, the federal government's fiscal deficit amounted to 3 percent of GDP in FY2018, lower than the 3.4 percent recorded in FY2017. Although expenditure was implemented as budgeted, revenue decreased as a percentage of GDP and in real terms, mainly due to the slow pace of tax reforms. The federal government fiscal deficit that accumulated during FY2018 was financed through external—mainly concessional—financing and domestic financing with large repayments of cash balances and residuals.

Total exports increased in FY2018, thanks to the good performance of service exports.

Goods exports declined due to the weak performance of coffee. Coffee represented 30 percent of goods exports and decreased by 5 percent in FY2018, 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. However, at US\$2.9 billion, manufacturing exports remain well below the targeted US\$7 billion. The underperformance of goods exports was mainly due to structural and competitiveness issues, such as rigid labor and product markets, including an overvalued exchange rate. However, Ethiopia's total exports expanded by 13.1 percent in FY2018, after years of underperformance. This sharp recovery in exports was driven by the growth in service exports, which accounted for half of total exports and expanded by 26.6 percent, mainly due to the strong performance of Ethiopian Airlines. Despite these positive developments, total exports of goods and services do not exceed 10 percent of GDP, significantly below the 24 percent expected from a country the size of Ethiopia at this level of development.

Following an increase of 13 percent in FY2018, total exports continued to expand by 18 percent in the first half of FY2019, driven by services.

Led by the performance of Ethiopian Airlines, service exports increased by 41 percent during the first half of FY2019 compared with the same period in FY2018. By contrast, merchandise exports decreased by 10 percent, reflecting the continued poor performance of Ethiopia's major export items, including coffee, oilseeds, and pulses. Manufacturing export performance was relatively strong, with exports of textiles and electronics posting growth rates of more than 35 percent.

Ethiopia's overall public debt showed an increase in FY2018 but moderated in the first quarter of FY2019.

Public debt declined from 57 percent of GDP in June 2018 to 54 percent in the first quarter of FY2019. External debt, which constituted about 55 percent of total public debt, decreased from 29.2 percent of GDP to 27.8 percent, while domestic public debt decreased from 27.8 to 26.1 percent of GDP between June and September 2018. In FY2018, public debt as a percentage of GDP increased to 57

percent compared with 54.9 percent in FY2017. The increase was mainly driven by external debt, which increased from 27.5 to 29.2 percent of GDP, while domestic debt marginally increased from 27.4 to 27.8 percent of GDP. Despite the strong outturn in service exports in FY2018, external debt vulnerabilities continue to arise from lower-than-expected export performance, keeping the two export-related indicators in the 2018 Debt Sustainability Analysis (DSA) above their respective thresholds in the baseline. As a result, the 2018 DSA maintained that Ethiopia remains at high risk of external debt distress, as was the case in the 2017 DSA.

Poverty continued to decline, particularly in urban areas, supported by strong GDP growth.

According to the most recent Household Living Standards Survey, 27 percent of Ethiopians lived below the international poverty line (US\$1.9 per capita per day, 2011 purchasing power parity (PPP)) in 2015/16, a decline from 34 percent in 2010/11. The reduction in poverty was strong in urban areas, but substantially slower in rural areas, parts of which were affected by the El Niño drought.



Ethiopia's real GDP growth remains strong despite decelerating to 7.7 percent in FY2018.

Outlook

The economic prospects for FY2019 and the medium term are expected to remain stable. The current reform agenda focusing on boosting private sector participation aims to support growth. Annual real GDP growth is projected to be around 7.9 percent in FY2019 and 8.2 percent in the medium term. The reform agenda proposed by the new prime minister is expected to address some macroeconomic imbalances, while moderate fiscal deficits and prudent monetary policy are expected to reduce the rate of inflation and keep it in the single digits. Merchandise exports could recover in the medium term, as large investment projects, such as the railway to the Port of Djibouti and large power dams (with potential for electricity exports) become operational.

On the supply side, growth in all sectors is projected to be robust. Agriculture is projected to continue growing at about 4 percent, as national main season crop production for 2018/19 is expected to be average, following forecasts of average rainfall during the main season (*mehar*) and *belg* season, except for localized areas in the northeastern and eastern parts of the country, which may face below-average seasonal rainfall (FEWS NET 2018). Industrial growth is expected to decline slightly in FY2019, to about 11 percent. The service sector is projected to continue expanding, due to the spillover effects from growth in other sectors.

In line with the government's reform, the private sector is expected to play an active role. Private investment is projected to increase by 10.6 percent, while government investment (public investment) is expected to decelerate. Household and government consumption are projected to decelerate temporarily. Although the general government fiscal policy stance is expected to remain relatively cautious (the FY2019 budget does not allow for any new investment projects), domestic revenue may be insufficient to finance the infrastructure investments foreseen in the

national development plan, so they will require public-private partnerships.

The federal government approved the FY2019 budget with a deficit targeted at 3.3 percent of GDP. Although the deficit targeted for FY2019 is higher than the fiscal deficit for FY2018, the FY2019 budget assumes a significant improvement in revenue collection while maintaining expenditures, especially capital expenditures, at the FY2018 level. Of the total budget approved for FY2019 (Br 346.9 billion), 26.4 percent is allocated to recurrent expenditure, 32.8 percent to capital expenditure, and 39 percent to regional transfers. Sixty-six percent of the budget is allocated to pro-poor expenditures focusing on education, health, industrial development, and the Urban Productive Safety Net.

The government is expected to continue its cautious fiscal policy stance. Government revenue is projected to increase gradually following tax reforms and improvements in tax compliance, while government expenditure, mainly capital expenditure, is expected to stabilize. As a result, the fiscal deficit would remain at 3 percent in FY2019 and further improve to reach 2.9 percent in FY2020. Although the general government fiscal policy stance is expected to remain relatively cautious (the FY2019 budget does not allow for any new investment projects), domestic revenue may be insufficient to finance the infrastructure investments foreseen in the national development plan. This would require innovative forms of finance for development.

Poverty is expected to continue its steady decline on the back of sustained economic growth and better climatic conditions for agriculture. However, the pace of poverty reduction is expected to be relatively slow, given the weak transmission between overall GDP growth and poverty reduction in Ethiopia. Based on past elasticities, poverty as measured by the international poverty line is projected to decrease to 22 percent by 2020.

Risks and Challenges

The medium-term sustainability of the growth model poses an important risk.

The key economic challenge relates to limited competitiveness, which may constrain the development of manufacturing, creation of jobs, and increase of exports. The pursuit of sound, private sector-led and export-oriented economic policies is therefore critical for achieving Ethiopia's economic and social ambitions.

Rising external imbalances constitute major challenges to the economy.

The lack of external openness, rising international oil prices, and an overvalued exchange rate (even after the 2017 devaluation) will continue to have adverse effects on competitiveness, affecting short-to-

medium-term growth. The rising risk to external debt sustainability may impact Ethiopia's access to external finance.

Political disruption associated with social unrest could derail the new reform agenda

and negatively impact growth through lower foreign direct investment, tourism, and exports. The outlook for poverty reduction, while broadly positive, also faces significant downside risks, given continued localized turmoil and large-scale displacement. As the special topic of this seventh Economic Update highlights, achieving stronger and broader-based improvements in household welfare will require strengthening the link between overall economic growth and increased opportunities for social and economic advancement for Ethiopia's young and rapidly growing population.

SPECIAL TOPIC: POVERTY AND HOUSEHOLD WELFARE IN ETHIOPIA, 2011-16

Improvements in Household Welfare, Challenges in Reaching the Rural Poor

Monetary welfare levels of Ethiopian households continued to improve between 2011 and 2016 despite adverse climatic circumstances linked to the El Niño drought.

Median household consumption expenditures per adult equivalent increased at the national, urban, and rural levels, although the increase was a lot stronger in urban than rural areas. The consumption expenditure of urban households increased at an annual average of 6 percent, while that of rural households increased at less than 1 percent per year. Overall, Ethiopian households' consumption levels increased by 2 percent per year between 2011 and 2016.

The increase in consumption was broadly shared across regional states, except for Amhara and Afar, where median household consumption levels decreased.

There was a pronounced urban-rural difference within regional states, with urban consumption levels growing everywhere but rural consumption increasing only in Tigray, Gambella, and Harari (in a statistically significant fashion). Household welfare levels increased in the highland and lowland regions of Ethiopia, with a sharper increase in the highlands.

Household consumption growth between 2011 and 2016 was stronger at the upper end of the distribution.

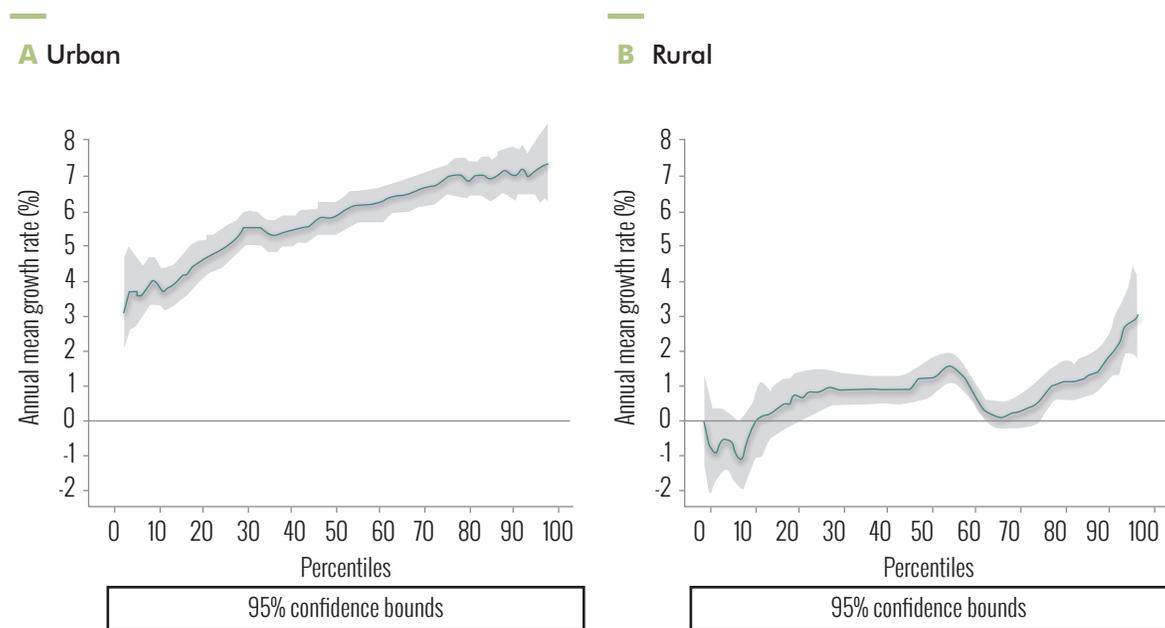
At the national level, the poorest 10 percent of the population did not experience any consumption growth between 2011 and 2016, while the top 10 percent grew at an average rate of 5 percent per year. The national

picture largely reflects the dynamics in rural areas, where the real consumption of the bottom 20 percent did not change between 2011 and 2016 (figure ES.1, panel b), a finding similar to the rural consumption dynamic during 2005–11. In urban areas, there

was strong growth across the distribution, although it was particularly strong for the better-off. As a result of the growth patterns, inequality in consumption levels somewhat increased, but it remains low in regional comparison.

Figure ES.1. Strong Growth in Urban Areas, but Low and Variable Growth in Rural Areas, 2011–16

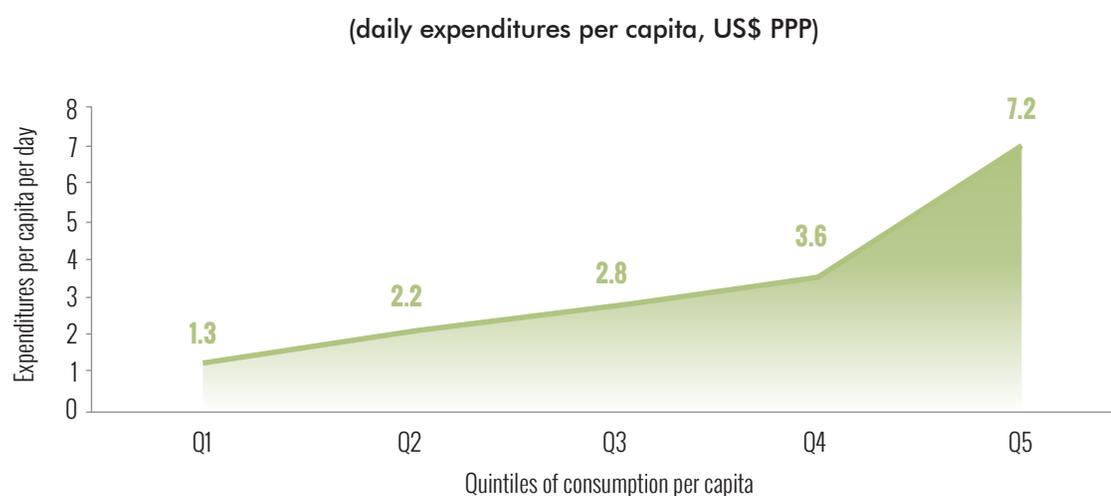
(average annual growth rates of consumption by percentile and urban/rural location)



Sources Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations

Despite 20 years of growth and development that have substantially reduced poverty levels, the monetary living standards of Ethiopian households remain low. This is especially true in rural areas and mainly for the bottom 40 percent. Expressed in U.S. dollars and adjusted for purchasing power, Ethiopians in the two bottom quintiles of consumption lived on US\$1.3

and US\$2.2 a day, respectively (figure ES.2). Between 2005 and 2016, while consumption levels were increasing overall, the bottom 15 percent in rural areas did not experience real consumption growth. The severity of rural poverty was higher in 2016 than in 2005, implying the existence of a segment of the rural population that has yet to benefit from Ethiopia's development (FDRE 2017).

Figure ES.2. Monetary Living Standards Remain Low for the Majority of the Population

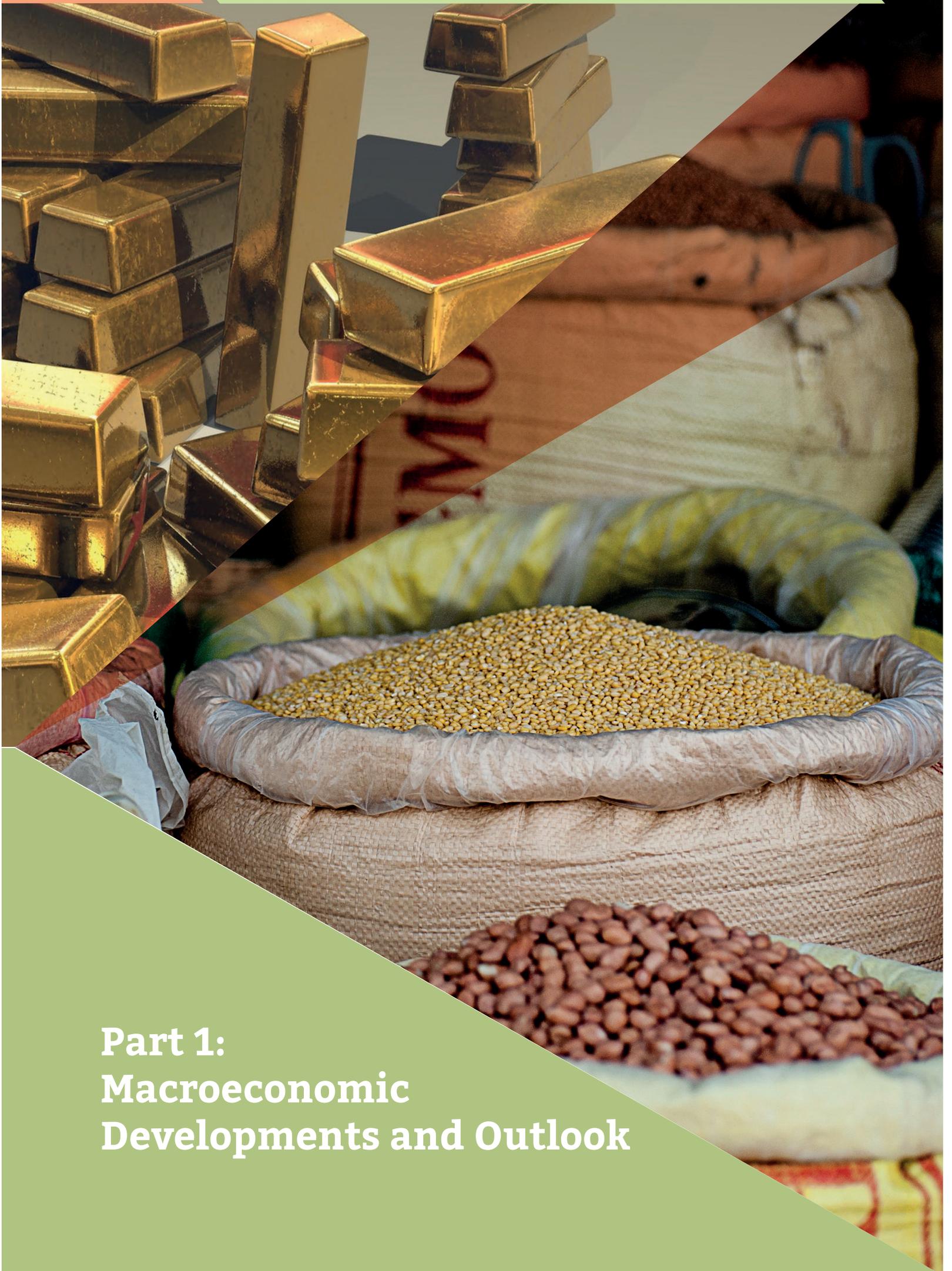
Sources Household Consumption Expenditure Survey 2016; World Bank staff calculations.

Education and Jobs—Key to Boosting Household Welfare Going Forward

Further improving the welfare levels of Ethiopian households will require, among others, more effective investments in human capital, especially education. In a scenario of development and transformation, children of poor households would accumulate more education and be able to move out and diversify into more productive activities, breaking the intergenerational transmission of poverty. Better-educated youth from rural areas tend to move to urban areas and improve their material conditions. Despite the government's large investments in education, few youths in the rural areas of Ethiopia complete primary school. According to the 2015/16 Welfare Monitoring Survey, 22 percent of youths ages 15-24 years in rural Ethiopia had completed primary school, dropping to 14 percent in the bottom quintile (the poorest in rural areas). Overall, the median years of education obtained by rural youth (ages 15-24) in Ethiopia amounts to five (lower for those in poor households). With these education statistics,

it is difficult to imagine that the living standards of today's poor children or youth will improve much as they enter adulthood and start their own families. Devising policies or interventions to keep children from poor rural families in school longer will be crucial in any attempt to share the benefits of growth more widely.

In a context of increasing land scarcity, the labor market will become increasingly important as a transmission mechanism between aggregate growth and poverty reduction. The Government of Ethiopia acknowledges this and expanding employment opportunities is a priority area in the second Growth and Transformation Plan. The challenge is daunting. Over the next 10 years, the working-age population in Ethiopia will grow at two million per year, dramatically increasing the population's demand for jobs. Even if Ethiopia's manufacturing drive turns out to be highly successful, the number of jobs created will not come close to the number required. Successfully addressing the employment challenge will require interventions, improvements, and innovations in many sectors and dimensions and a critical review of existing employment policies and strategies.



**Part 1:
Macroeconomic
Developments and Outlook**

1.1 Global and Regional Trends

Global growth is projected at 3.7 percent for 2018, continuing the steady expansion underway since mid-2016.

However, the expansion has become less balanced and may have peaked in some major economies. Downside risks to global growth have risen in recent months in a context of rising political uncertainties. The reversal of capital flows to emerging market economies with weaker fundamentals and higher political risk has become more pronounced, while trade barriers are on the rise. Although financial market conditions remain accommodative in advanced economies, they could tighten rapidly if, for example, trade tensions and policy uncertainty were to intensify. Monetary policy is another potential trigger, and tighter financial conditions in advanced economies could cause disruptive portfolio adjustments, sharp exchange rate movements, and further reductions in capital inflows to emerging markets (IMF 2018b).

With risks shifting to the downside, there is greater urgency for policies to enhance prospects for strong and inclusive growth.

According to the 2018 World Economic Outlook, avoiding protectionist reactions to structural change and finding cooperative solutions that promote continued growth of trade in goods and services remain essential to preserve the global expansion. With shrinking excess capacity and mounting downside risks, many countries need to rebuild fiscal buffers and strengthen their resilience to an environment in which financial conditions could tighten suddenly and sharply (IMF 2018b).

Economic growth in Sub-Saharan Africa is estimated to have picked up to 2.7 percent in 2018 from 2.3 percent in 2017, barely above population growth (World Bank Group 2018). The acceleration relative to 2017 reflects stronger global growth, higher commodity prices, and improved capital market access, following efforts to improve fiscal balances in the aftermath

of the commodity price slump. Although the region's economic recovery continues, it does so at a slower pace than expected (0.4 percentage point lower than the April 2018 forecast). On the supply side, the moderate recovery reflected higher oil prices and better agricultural conditions following droughts. On the demand side, growth was supported by consumer spending amid eased inflation and public investment—especially among non-resource-rich countries. However, the external environment is becoming less favorable for Sub-Saharan Africa, as global trade and industrial production are losing momentum. The prices of metals and agricultural commodities fell due to concerns about trade tariffs and weakening demand prospects, while oil prices were on an upward trend and are likely to remain elevated in 2019. Financial market pressures intensified in some key emerging markets and developing economies. Concern about dollar-denominated debt has risen among emerging markets amid a stronger U.S. dollar.

Public debt levels remained high and continued to rise in several Sub-Saharan African countries.

Changes in the composition of debt—characterized by growing liabilities owed to non-Paris Club governments and private creditors—have increased the vulnerability of public debt sustainability to weaker currencies and higher global interest rates. Although the external positions of oil exporters improved, they weakened in metals exporters and non-resource-rich countries.

Growth in Sub-Saharan Africa is expected to rise to 3.3 percent in 2019.

Despite relatively solid growth, average growth per capita will remain weak, pointing to continued slow progress in poverty reduction. Structural constraints hinder a stronger rebound in the region's largest economies, and growth is expected to rise moderately in 2020 to reach 3.6

percent. Risks to the growth outlook are tilted to the downside, reflecting vulnerabilities related to tighter global financial conditions, the reversal of capital inflows, and higher financing costs. Key external risks include an unexpectedly sharp decline in

commodity prices, an abrupt tightening of global financial conditions, and escalating trade tensions between major economies. The main domestic risks are fiscal slippage, domestic conflicts, and weather shocks (World Bank Group 2018).

1.2 Recent Economic Developments and Outlook

Real Sector in Ethiopia

Real gross domestic product (GDP) growth, while still strong, decelerated to 7.7 percent in FY2018 (Figure 1.1.). A slowdown in industrial growth, mainly driven by lower growth in construction due to foreign exchange shortages and higher prices of imported construction materials, coupled with weaker performance of the manufacturing and the agriculture sectors explains to a large extent the

growth deceleration. For example, main season crop production, which covers about 90 percent of total crop production, recorded growth of 5.4 percent, which was lower than the growth rate reached in FY2017 (a recovery year) (Figure 1.2.). Similarly, although crop productivity growth was generally strong, it remained below the growth in FY2017 (Figure 1.3.).

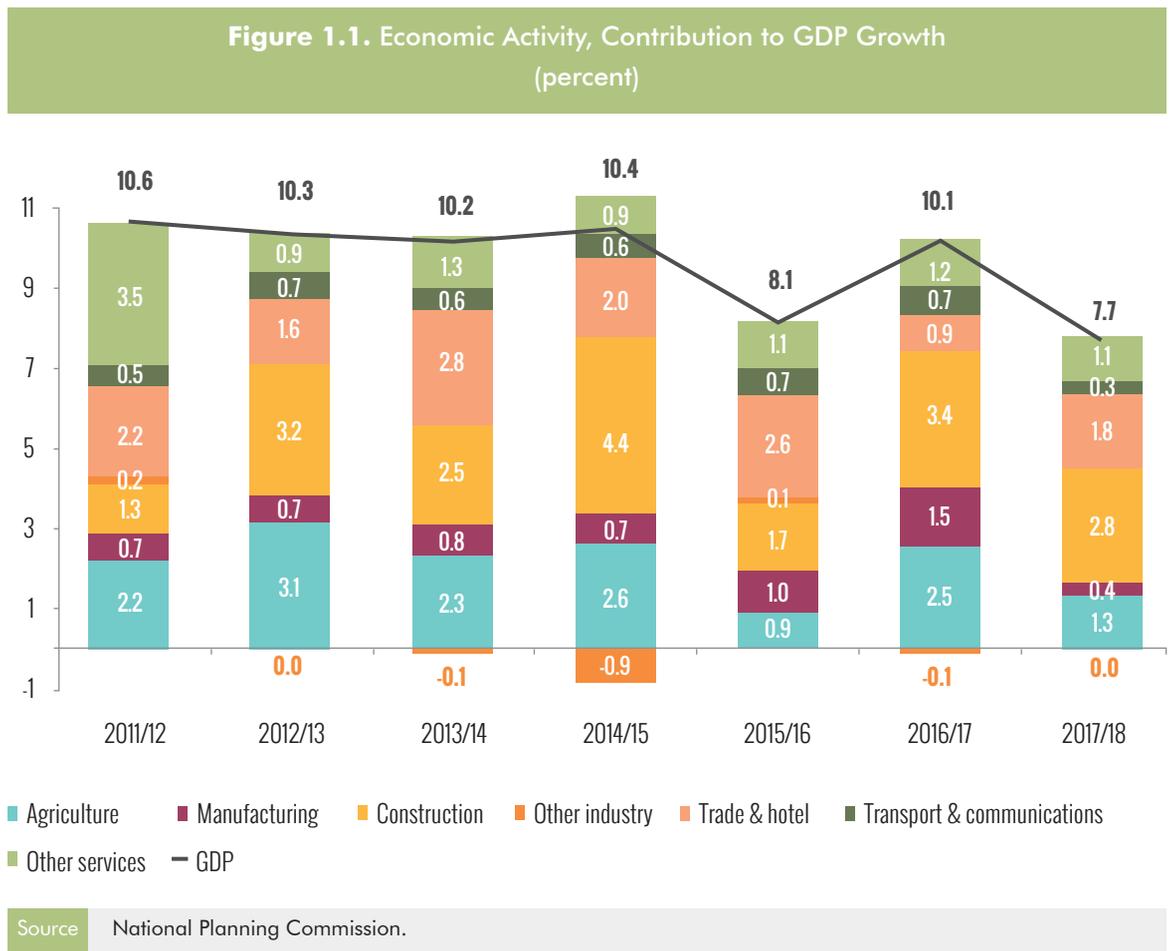
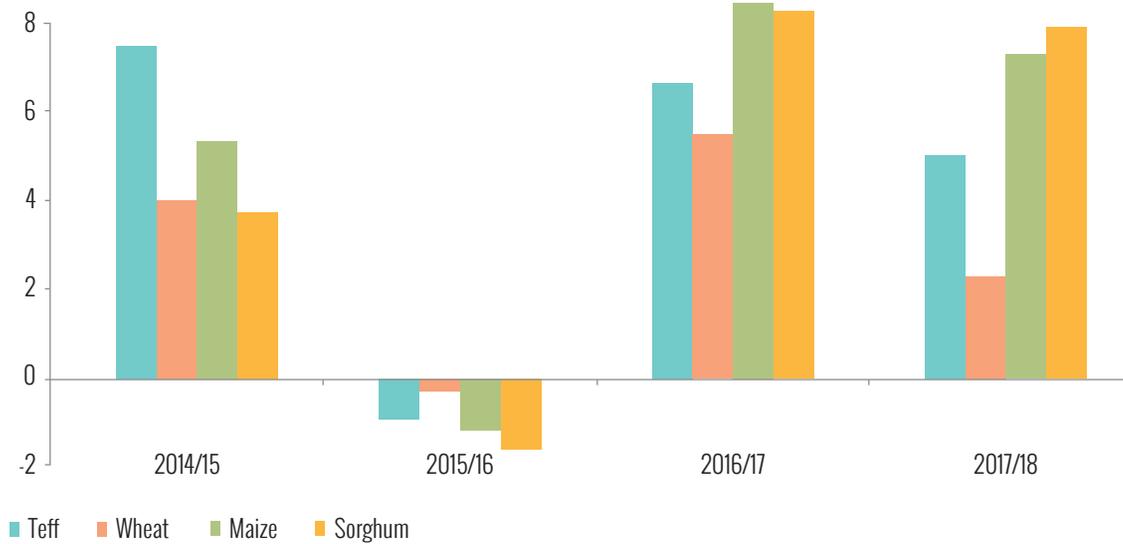


Figure 1.2. Crop Growth during the Main (Meher) Season
(percent)



Source Central Statistical Agency.

Figure 1.3. Productivity Growth of Major Crops
(percent)



Source Central Statistical Agency.

Real GDP growth was mainly driven by services. Of the 7.7 percent real GDP growth, the service sector contributed 3.3 percentage points, followed by industry at 3.1 percentage points, and agriculture at 1.3 percentage points. Despite good crop production (5.4 percent annual growth), agricultural value added dropped by half. Compared with the previous year, the growth contribution of the agriculture sector dropped by 50 percent, and that of industry dropped by 34 percent.

Industrial sector growth slowed. Industrial sector growth slowed due to underperformance in the manufacturing and construction subsectors. Between 2012/13 and 2016/17, the industrial sector grew on average by 22 percent. However, the growth rate dropped to 12.2 percent in 2017/18, showing a cut by 40 percent from the growth rate in 2016/17, and a drop by 45 percent from the historical five-year average growth of the sector. The construction subsector, the main driver of industrial sector growth, grew by 28 percent between 2012/13 and 2016/17. However, the growth rate in 2016/17 declined to 15.7 percent, showing a drop of 24 percent compared with the previous year, and a drop of 44 percent from the five-year historical growth rate.

Manufacturing underperformed. In addition to the prevailing structural- and trade logistics-related challenges, foreign exchange shortages and political unrest severely affected the manufacturing sector over the past three years, with the magnitude of the effect peaking in FY2018. As a result, manufacturing growth dropped drastically, from 24.7 percent in FY2017 to 5.5 percent in FY2018. Large and small-scale industries underperformed dramatically in FY2018 compared with their historical five-year average growth rates. Between 2012/13 and 2016/17, large and small-scale industries registered average growth of about 22 and 9.9 percent, respectively. However, the growth rates of large and small-scale industries in 2017/18 (6 and 4.6 percent, respectively) were far below the historical trends, dropping by 73 and 54 percent, respectively, leading to a drop in manufacturing growth. The drastic fall in growth may also be explained by measurement issues; box 1.1 discusses how to deal with the questions raised by inconsistencies in GDP estimates in the System of National Accounts. By contrast, service sector growth increased from 7.5 percent in FY2017 to 8.8 percent in FY2018. Agricultural growth decelerated from 6.7 percent in FY2017 to 3.5 percent in FY2018, mainly due to slower growth of crop production.

Box 1.1

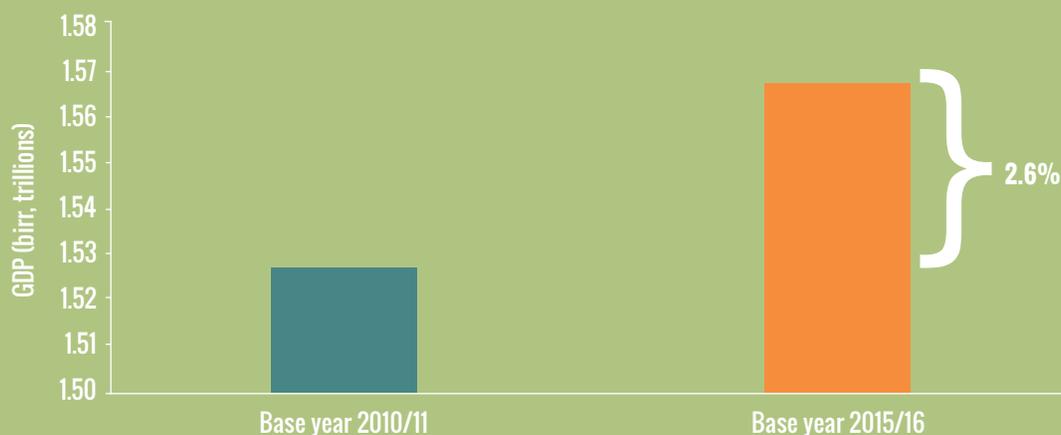
How to Deal with Inconsistencies in GDP Estimates in the System of National Accounts?

In principle, a change of base year in the national accounts involves changing the price and quantity base for the individual price and quantity relatives and updating the weights used in aggregating the individual quantity relatives into sub indexes. At the same time, the base year change serves to reconcile the different estimates of gross domestic product (GDP) to enable methodological and conceptual reviews and improvements. The recent rebasing in Ethiopia has led to

changes in the size of GDP, growth rates, and sectoral contributions.

In FY2018, the National Planning Commission (NPC) revised the base year from 2010/11 to 2015/16. Due to rebasing, nominal GDP has shown a 2.6 percent increase (figure B1.1.1), while GDP at constant market prices increased by 94 percent, from Br 810 billion to Br 1.7 trillion over the same period.

Figure B1.1.1 Comparison of Nominal GDP in 2010/11 and 2015/16 Base Years



The revision of GDP at constant prices by activity has brought significant changes in the value added of all activities, most notably in the service sector: private households with employed persons increased by more than nine-fold; in the industrial sector, construction and small and cottage industries increased by more than twofold; agriculture doubled; and most activities have seen similar increases (figure B1.1.2). As a result, GDP in constant prices doubled.

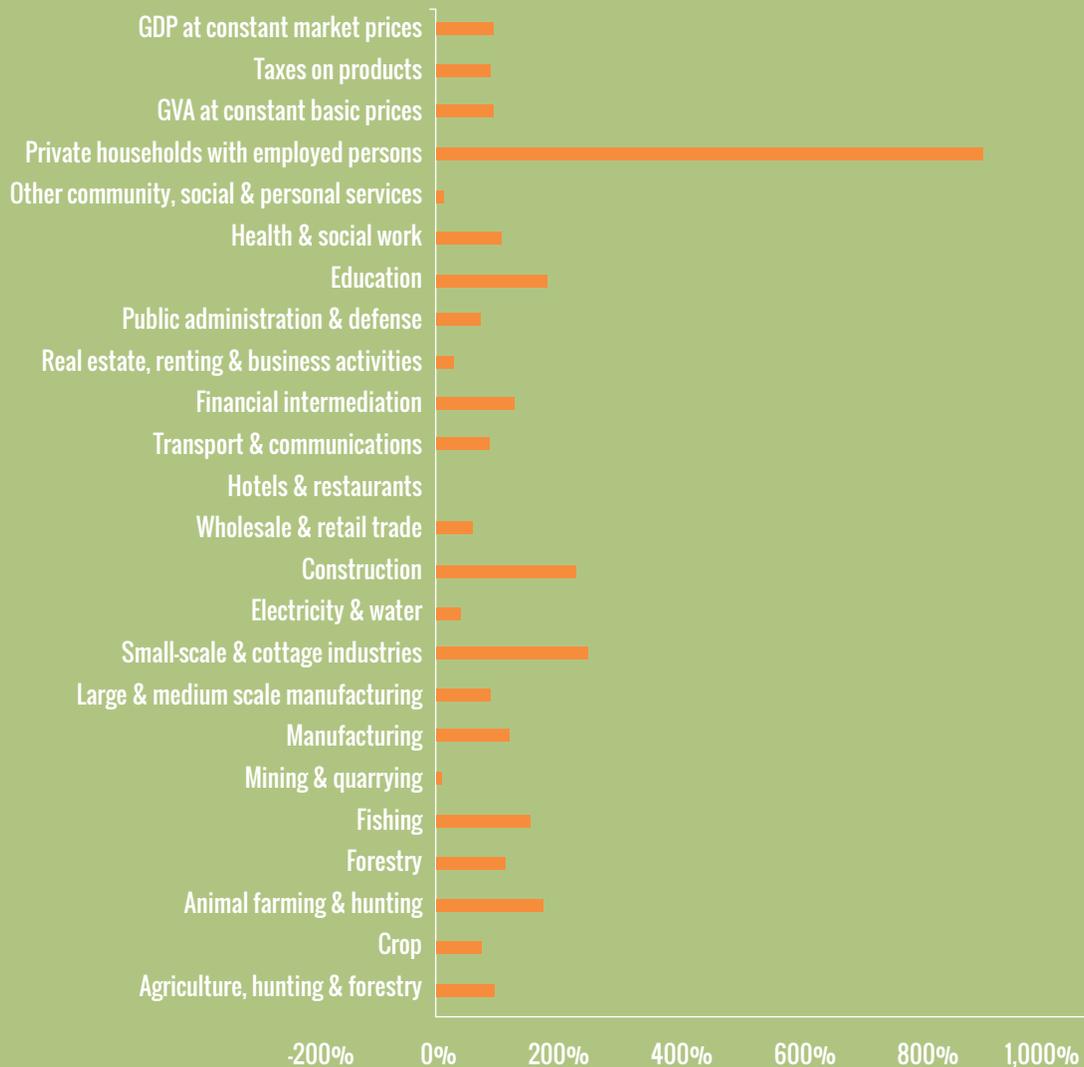
Most importantly, after the rebasing in 2016/17, real GDP growth for 2016/17 was reported to reach 10.9 percent. However, the growth rate for 2016/17 was reduced to 10.1 percent in the recent NPC report. In the new GDP estimate for 2016/17, value added for agriculture and industry was revised upward by 2 percent, while value added for services was reduced by 0.2 percent.

An in-depth sectoral analysis reveals that value added in small and cottage industries increased by 51 percent; value added in hotels and restaurants increased by 25 percent; and the value addition in financial intermediation decreased by 17 percent. The 2016/17 growth rate for small and cottage industries of 2.5 percent was revised to 36.9 percent in 2018; by contrast, for education, the 2016/17 growth rate of 11 percent was revised down to -3.2 percent in 2018.

The growth estimates for 2017/18 bring out further inconsistencies. Agriculture value addition in constant prices was estimated to increase only by 3.5, despite crop production growth of 5.4 percent; furthermore, livestock value addition was estimated to drop by 0.6 percent, from 4.2 percent growth in the previous year, without a proper explanation.

Incorrect GDP estimates lead to policy mismanagement.

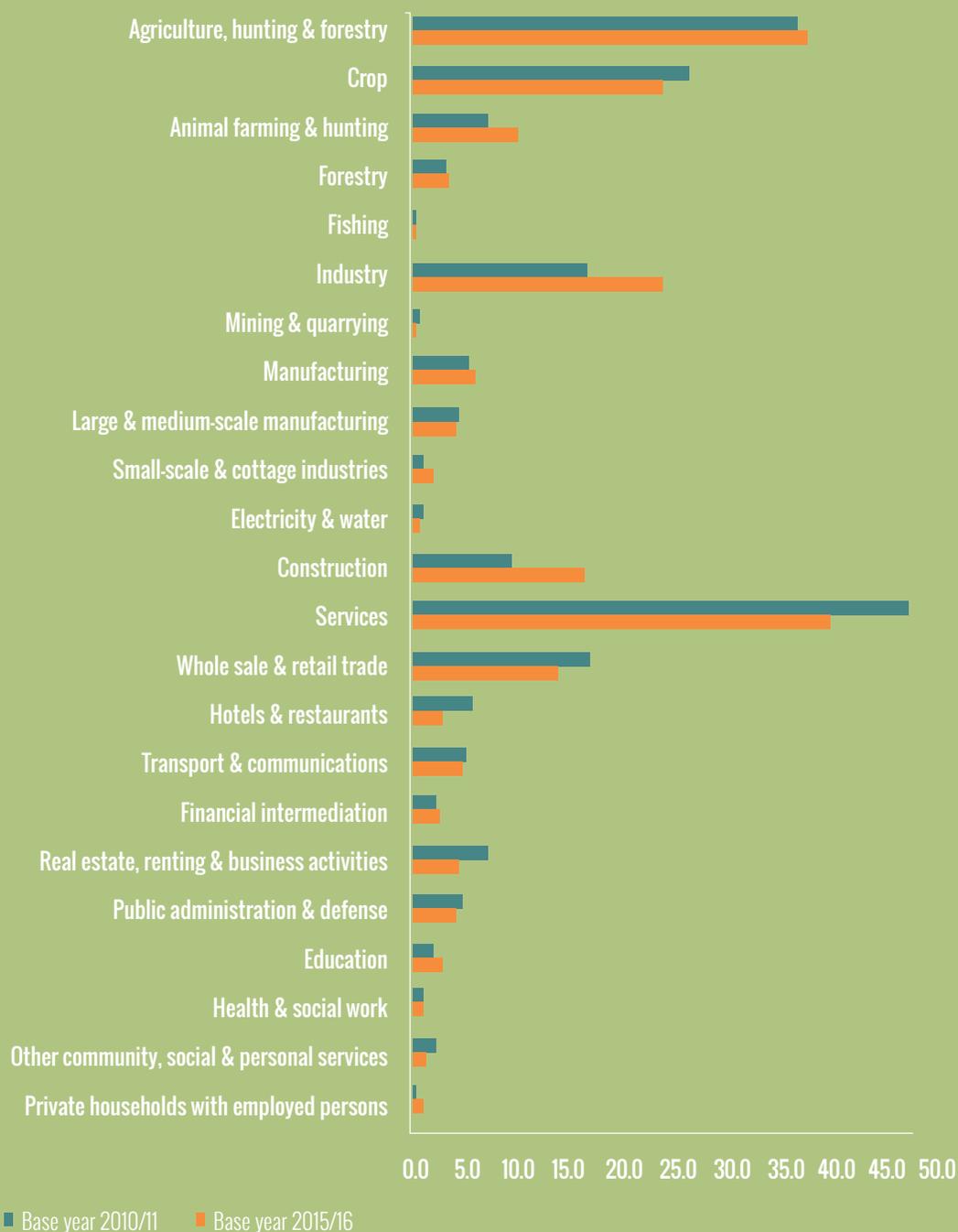
Figure B1.1.2 Change in 2015/16 GDP between the 2010/11 and 2015/16 Base Years, by Industry



It is evident that, due to the change in the base year from 2010/11 to 2015/16, the shares of industry and agriculture increased while the share of services declined. Yet, services continue to account for the highest share in GDP in both base years. In the agriculture sector, the share of crops declined, while in the service sector, the shares of wholesale and retail trade and hotels and restaurants declined in the 2015/16 base year. The

highest drops are observed in the shares of hotels and restaurants and real estate, renting, and business activities. The declines in wholesale and trade and hotels and restaurants might be due to the high cost of inputs that may have reduced the value added despite the expansion of activities. The highest increases are observed in small-scale and cottage industries and construction (figure B1.1.3).

Figure B1.1.3 Percentage Shares of 2015/16 GDP, between 2010/11 and 2015/16 Base Years, by Industrial Classification



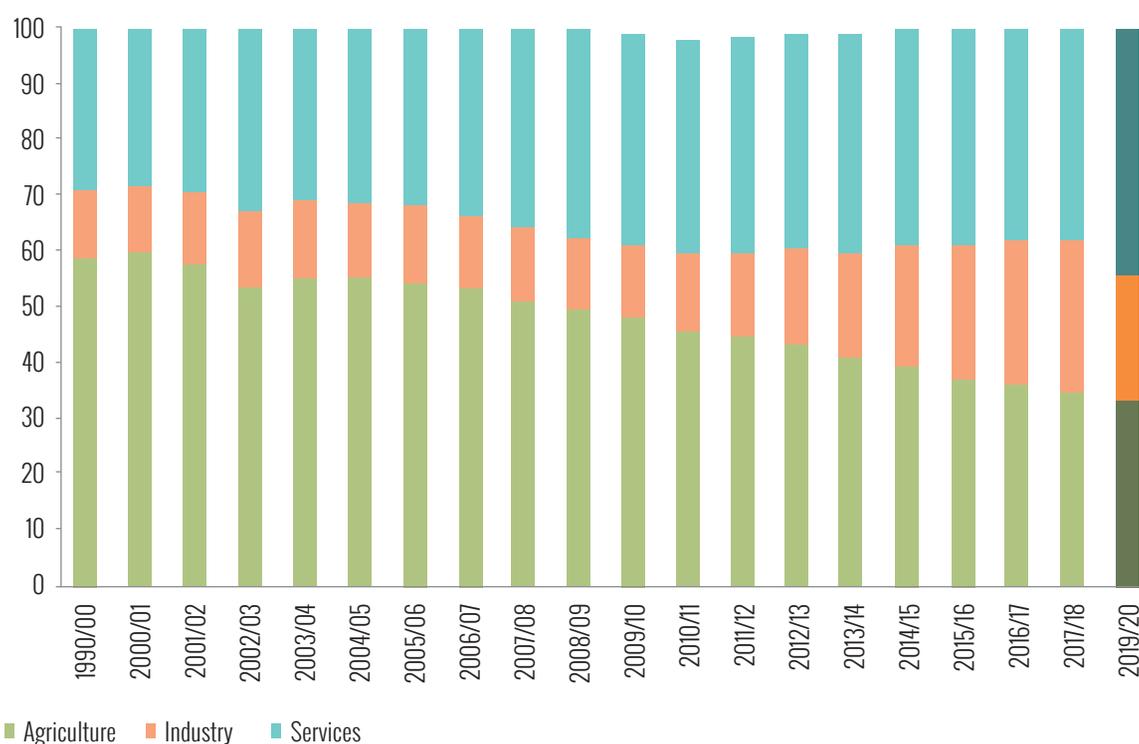
In general, incorrect GDP estimates can lead to mismanagement of monetary policy, including inadequate measures to deal with inflation, and can provide confusing signals for managing

foreign exchange reserves. Technical assistance to the NPC and other institutions could help address remaining issues with the rebasing and forthcoming GDP forecasts.

Ethiopia has experienced a remarkable shift from agriculture to services and industry over the past 15 years. The share of agriculture in GDP declined from 55 percent in 2003/04 to 35 percent in 2017/18, while the share of industry more than doubled, from 13 to 27 percent, and the share of services increased from 33 to 39 percent (figure 1.4). However, Ethiopia did not witness the movement of the

workforce from agriculture to manufacturing and services that is consistent with a long tradition in development economics. Traditionally, poor countries undergo a process of structural change, with labor reallocating from traditional, low-productivity sectors of the economy toward modern, high-productivity sectors to achieve high levels of aggregate productivity (Lewis 1954; Chenery et al 1986).

Figure 1.4. Sectoral Shares in Gross Domestic Product (percent)



■ Agriculture ■ Industry ■ Services

Source National Planning Commission.

Note The values for 2019/20 are targets of the second Growth and Transformation Plan.

The reallocation of labor from agriculture to manufacturing has been constrained by the slow pace of manufacturing expansion. Agriculture continues to dominate employment, with a minimal decline in the employment share in agriculture between 2005 and 2013. This points to inadequate expansion of the manufacturing

sector that would result in rapid migration of labor to the urban informal service sector. Between 2005 and 2013, the share of employment in agriculture declined by 7.5 percentage points, whereas the share of agriculture value added dropped by 11.5 percentage points. Over the same period, the employment share of the service sector increased

by 8.7 percentage points, absorbing the labor released from agriculture and industry, and increased its share of value added in GDP by 5.4 percentage points. The longer-run sustainability of the Ethiopian model is further undermined by

recent unemployment data. After a long period of decline, there was an increase in urban unemployment in Ethiopia between 2016 and 2018, mainly in female and youth unemployment (box 1.2).

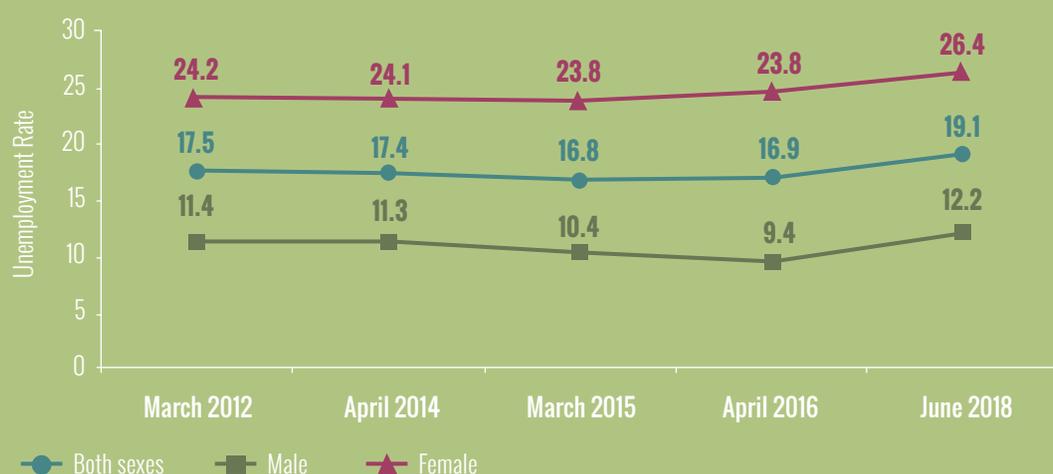
Box 1.2

Labor Market Developments and Poverty in Ethiopia: Increasing Unemployment, Especially among Women and Youth

Getting a job is often an important pathway out of poverty in Ethiopia. The official urban unemployment rate increased from 17.5 percent in 2012 to 19.1 percent in 2018 (figure B1.2.1). Interestingly, after

three consecutive years of decline, urban unemployment increased in 2018, with the female unemployment rate (26.4 percent) more than double the male rate (12.2 percent).

Figure B1.2.1 Unemployment Rate in Urban Areas



Source: Central Statistical Agency 2018.

Young people are also particularly affected by unemployment. At 25.3 percent, the unemployment rate for youth is higher than the national average of 19.1 percent, with female youths bearing the brunt of unemployment: 30.9 percent of young women were unemployed in

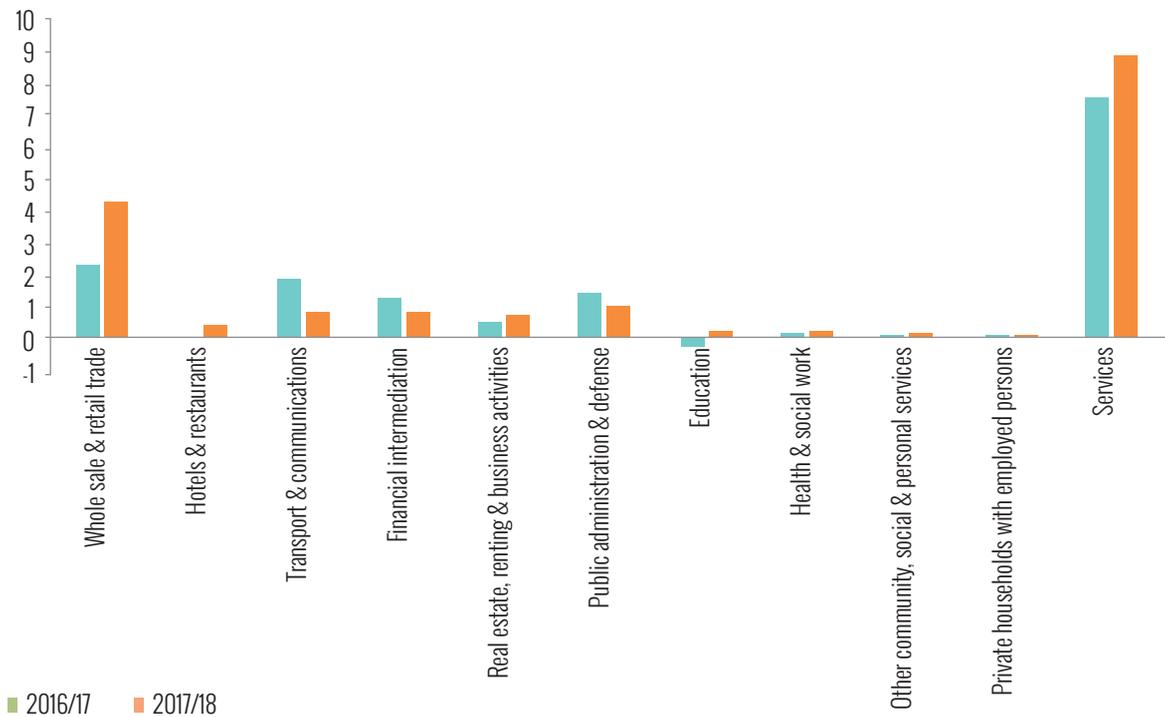
2018 compared with 19 percent of young men.

Among the regions, Dire Dawa has the highest unemployment rate at 25.3 percent, followed by Tigray at 21.5 percent, Addis Ababa at 20.2 percent, and Amhara at 19.7 percent.

The service sector contributed 44 percent of the real GDP growth. With a growth contribution of 3.4 percent, the service sector was the leading contributor to the 7.7 percent growth of GDP in FY2018. In the service sector, wholesale and trade contributed 22 percent to the overall GDP growth and 50 percent to the growth in the service sector GDP. The performance of the service sector and the wholesale and trade subsector showed a huge improvement compared with FY2017, when the service sector's growth contribution was 3 percent (30 percent of the overall growth), whereas the contributions of

wholesale and trade to the overall GDP growth and the service sector GDP growth were 9 and 30 percent, respectively. The growth rate of transport and communication dropped to single digits, at 6.4 percent, for the first time since 2010/11, and decreased by more than twice compared with the level in FY2017 (15.1 percent). Accordingly, the contributions of the transport and communication subsector to overall GDP dropped by 55 percent, from 0.7 to 0.3 percentage point. Similarly, the contribution of the same subsector to service sector GDP dropped by 58 percent, from 2 percentage points to 0.8 percentage point (figure 1.5).

Figure 1.5. Service Sector Performance (percent)



Source National Planning Commission.

Inflation and Monetary Policy in Ethiopia

Inflation showed a declining trend in the first half of FY2019, after surging to double digits in FY2018. Since reaching 16.8 percent in June 2018, due to the expansion of public sector credit in 2017, broad money growth, pass-through of the October 2017 devaluation, and political disruptions (which adversely affected distribution networks), inflation has been on a declining trend. It reached a low of 10.4 percent

in December 2018. The price deceleration has been more rapid for food products, whose price inflation decreased from 17.8 percent in June 2018 to 11.4 percent in December 2018, compared with nonfood items, whose price inflation decreased only marginally (from 11.1 to 9.1 percent during the period). There was a slight uptick in inflation, to 10.8 percent in January 2019 (figure 1.6).

Figure 1.6. Inflation
(year-on-year, percent)



Source Central Statistical Agency.

Although growth in monetary aggregates was strong in FY2018, there was a significant reduction during the first half of FY2019.

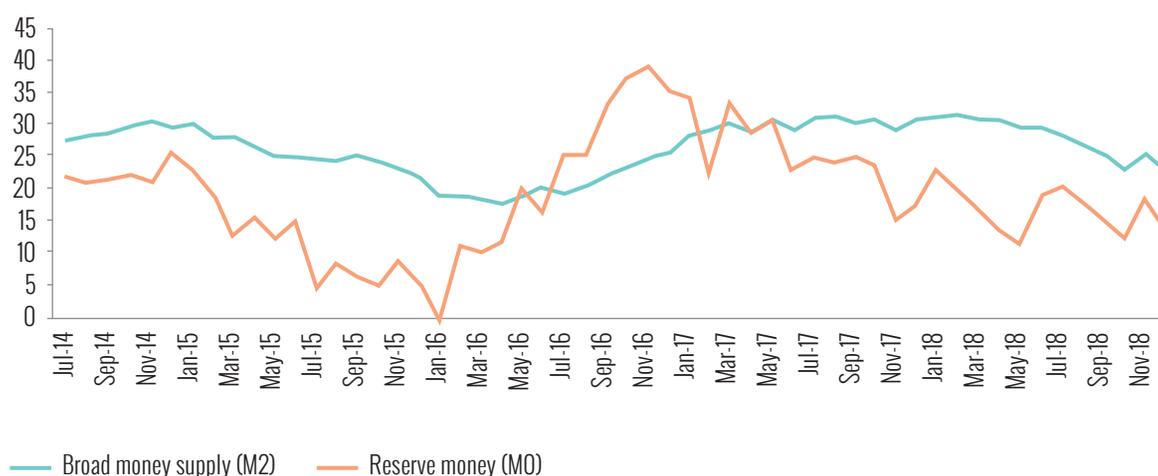
Growth in reserve money (base money), which is the operating target for the National Bank of Ethiopia's (NBE's) monetary policy, dropped to 12.8 percent in December 2018 compared with 19.1 percent in June 2018. Accordingly, broad money expansion was significantly curtailed (from 29.2 percent in June 2018 to 22.2 percent in December 2018). Growth in monetary aggregates

was strong in FY2018 despite the NBE's restrictive policy measures implemented in the aftermath of the October 2017 devaluation. The NBE lowered its reserve money target for FY2018, from 22 to 16 percent; limited credit expansion to sectors other than exports and manufacturing to 16 percent; and raised the minimum interest rate from 5 to 7 percent, in an effort to contain the pass-through effect of the October 2017 devaluation. Although the NBE managed to reduce reserve money growth from about 24 percent in the

months before the devaluation to 19.1 percent in June 2018, it missed the target of 16 percent announced following the devaluation. Growth in

broad money supply was also strong, reaching 29.2 percent in June 2018 compared with 28.8 percent in June 2017 (figure 1.7).

Figure 1.7. Broad Money and Reserve Money
(year-on-year, percent)



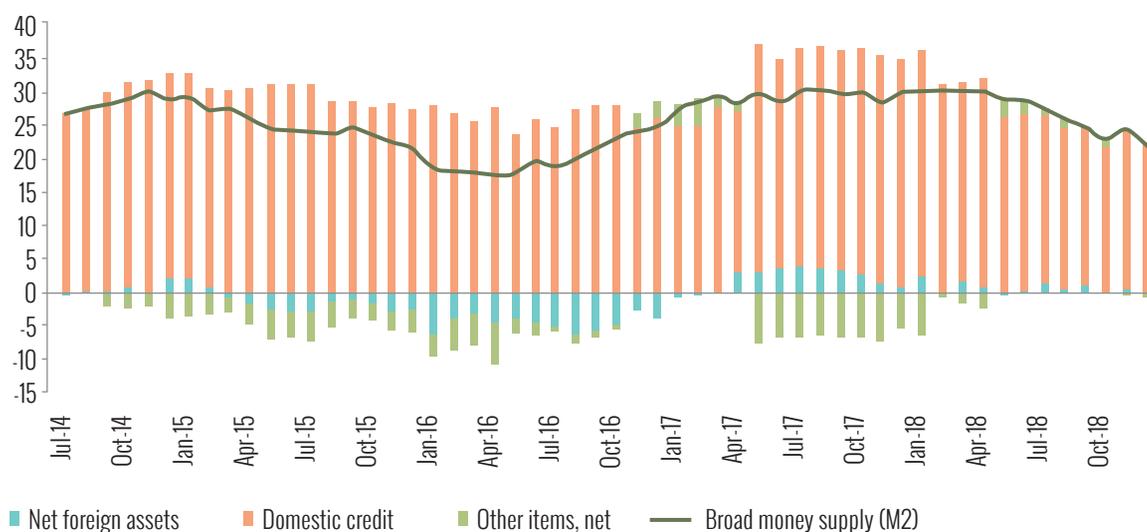
Source National Bank of Ethiopia.

Expansion of domestic credit was the main driver of growth in broad money supply (M2). Domestic credit expanded by 24.3 percent in June 2018—slowing from the 28.7 percent expansion in June 2017—while net foreign assets showed only a modest increase of 3.5 percent. Credit to the government increased by 19.4 percent—significantly less than its growth rate of about 80 percent the previous year—reflecting the government’s cautious fiscal policy stance in FY2018. Credit to the nongovernmental sectors grew by 25.1 percent, slightly higher than the

previous year’s growth (23.3 percent). Of the nongovernmental sectors, credit growth to state-owned enterprises (SOEs) remained broadly stable, as in the previous fiscal year, at around 21 percent, reflecting continued slowdown in investments by SOEs. Growth in credit to the private sector increased from 27.7 to 30.1 percent (figure 1.8). Looking at the composition of domestic credit, the share of SOEs continued to decline, as was the case in FY2017, while the share of the private sector increased slightly. The share of the central government decreased slightly (figure 1.9).

The share of the private sector in domestic credit has increased, while the share of SOEs and the central government decreased in FY2018.

Figure 1.8. Contribution to Broad Money Growth
(year-on-year, percent)



Source National Bank of Ethiopia.

Figure 1.9. Composition of Domestic Credit
(percent)



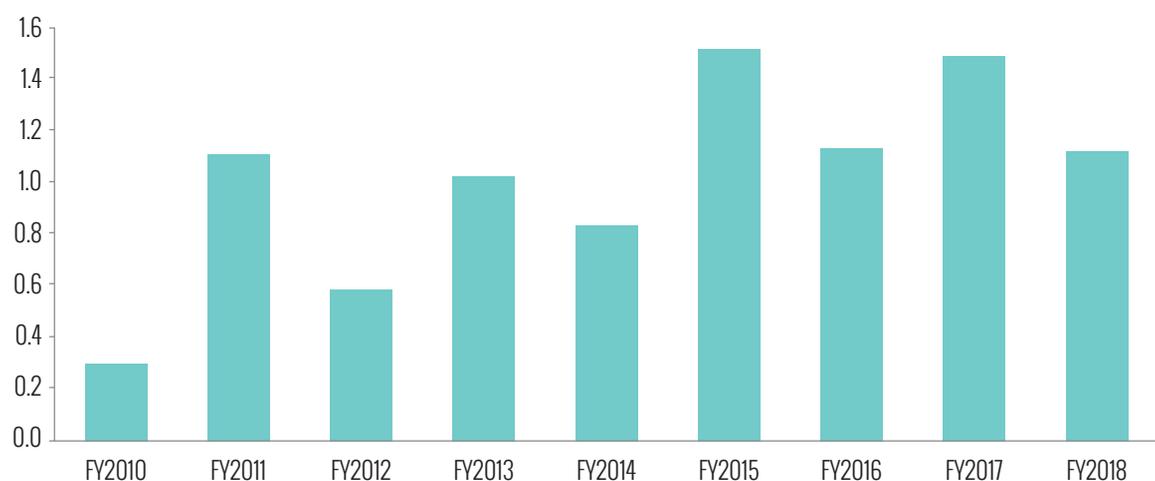
Sources National Bank of Ethiopia.

Note SOEs = state-owned enterprises.

Treasury bills and NBE advances are the main instruments for the government's domestic financing of its deficit. In FY2018, government borrowing through T-bills covered about 60 percent of total government borrowing; the remaining 40 percent was filled through NBE advances (figure 1.10). In the previous fiscal year, NBE advances covered about 63 percent. NBE advances have remained significant over the past

few fiscal years, amounting to about 1.3 percent of GDP. This significant level of borrowing from NBE has obviously been an important factor in the inflationary pressures experienced over the past few years. It has been compounded by nonmarket-based borrowing through T-bills, which relies heavily on a limited number of captive investors (predominantly public bodies) that are buying the bills at significantly below market rates (box 1.3).

Figure 1.10. National Bank of Ethiopia Advances to the Government
(percent of gross domestic product)



Source: National Bank of Ethiopia.

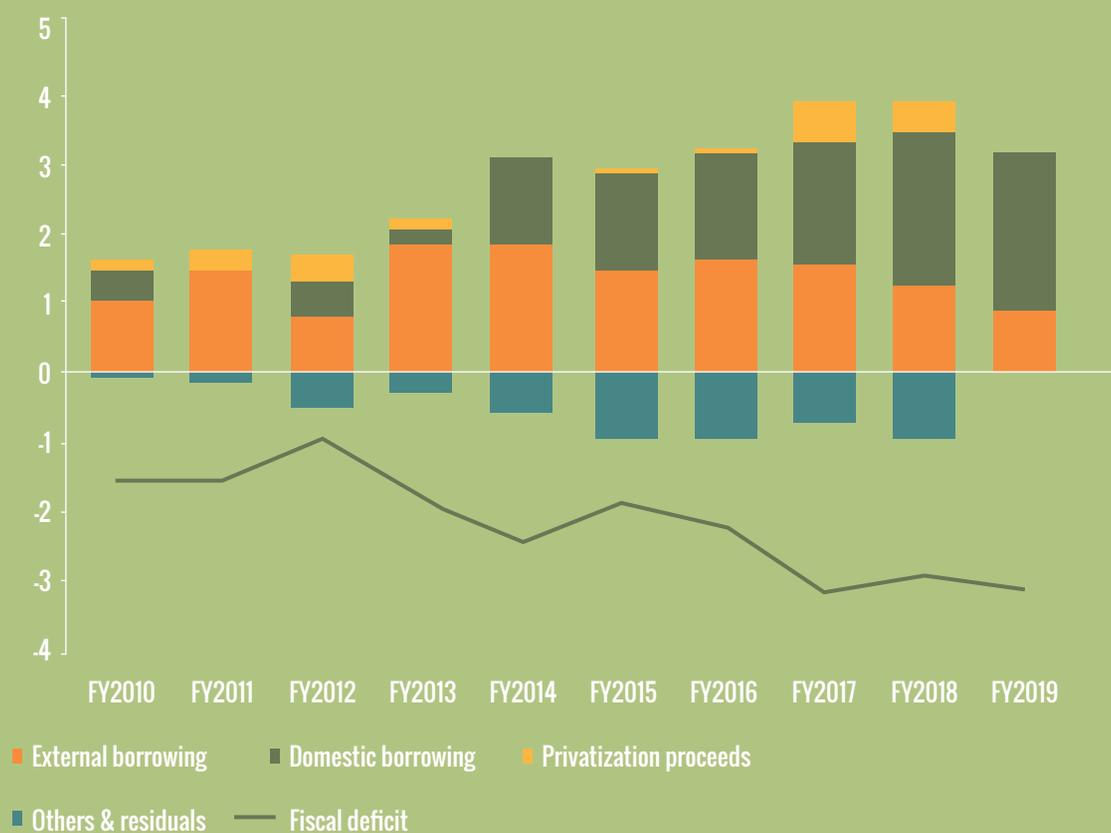
Box 1.3

Reforming Government Domestic Financing Mechanisms: Toward the Development of a Domestic Government Debt Market

Domestic borrowing has become an important source of financing the deficit during the past five years. Deficit financing through domestic borrowing, which was below

0.5 percent of gross domestic product (GDP) about five years ago, has been increasing over the past years, reaching more than 2 percent of GDP last fiscal year (figure B1.3.1).

Figure B1.3.1 Fiscal Deficit and Financing
(percent of GDP)



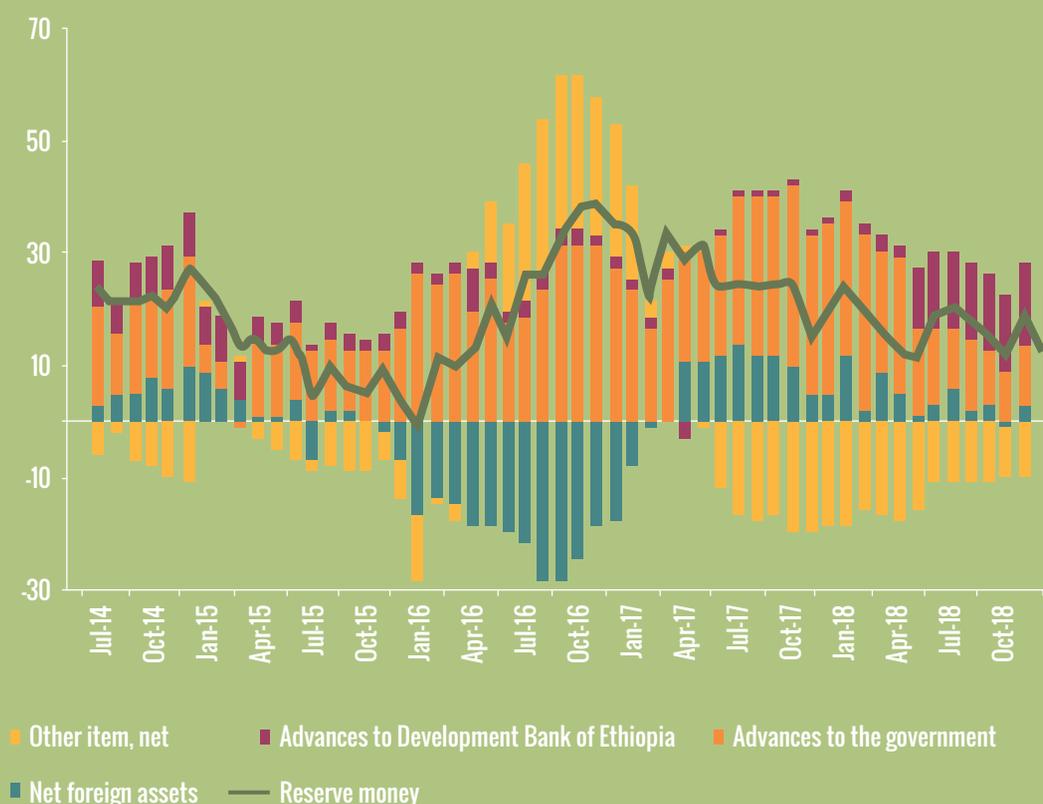
Source: Ministry of Finance and Economic Cooperation.

The number of instruments the government uses for domestic borrowing has remained very limited. There are two main domestic financing instruments for the government: advances from the National Bank of Ethiopia (NBE) and Treasury bills. Direct advances from the NBE involve the provision of an overdraft facility to the government and are essentially monetary financing of the deficit. Over the past decade, on average nearly 60 percent of the government's domestic borrowing was through such advances from the NBE.

There are no statutory limits set on the amount of direct advances that the government can

draw from the NBE in any given fiscal year. The National Bank of Ethiopia Establishment Proclamation, which was amended in 2008, states that the amount of advances and credit that NBE extends to the government for each fiscal year will be determined through consultations between the NBE and the government, and that it should be consistent with the maintenance of price and exchange rate stability. The interest rate the government pays on such advances from the NBE has remained unchanged at 3 percent for more than a decade. Moreover, these advances have been the major driver of reserve money growth (figure B1.3.2).

Figure B1.3.2 Contribution to Reserve Money Growth
(year-on-year, %)



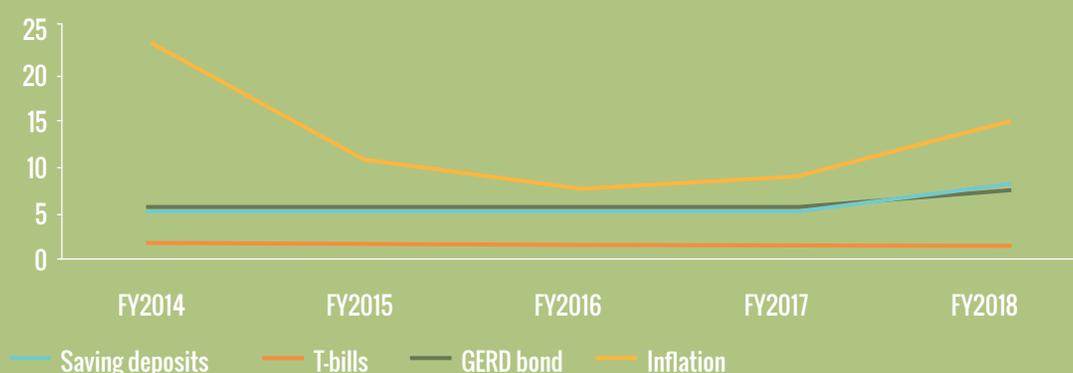
Source National Bank of Ethiopia.

Although the government started selling T-bills in 1995, the T-bill market has remained undeveloped. The number of participants in T-bill auctions has remained limited, and the yield on T-bills has been very low. In recent years, T-bill sales have been limited to a handful of captive investors, including the pension funds for public and private sector employees and very few state-owned enterprises (including the Development Bank of Ethiopia). Over the past five years, T-bill holdings of the pension funds and the Development Bank of Ethiopia together

accounted for over 95 percent of the total T-bill outstanding balances.

Investment options for the pension funds are restricted through their respective establishment proclamations such that T-bills are the only instrument in which they can invest their funds. The pension funds are essentially required to buy T-bills using the funds they mobilize. The return on the T-bills is below the minimum interest rate paid for deposits and well below the inflation rate, meaning negative returns in real terms (figure B1.3.3).

Figure B1.3.3 Interest Rates and Inflation
(percent)



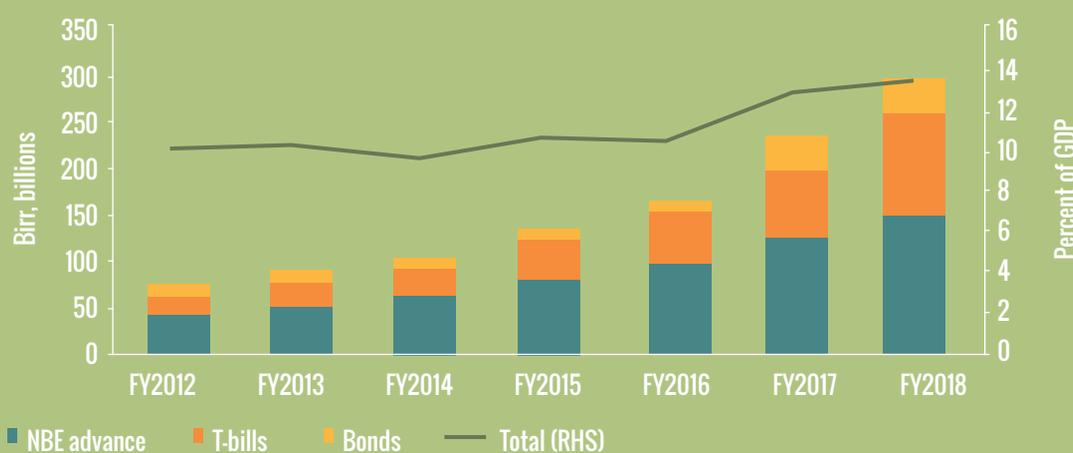
Sources National Bank of Ethiopia.

Note Grand Ethiopian Renaissance Dam (GERD) bonds are issued to raise money for the construction of the dam.

As part of the developmental state model, the government's strategy for financing its deficit from domestic sources over the past years focused on using sources of funds with relatively low cost. By making use of administrative measures, the government has been able to obtain financing domestically at substantially below market interest rates. The stock of

debt accumulated through such financing has been increasing rapidly over the past few years. The stock of domestic debt of the government, which was about 11 percent of GDP five years ago, rose to 14 percent in FY2018. Of the total domestic debt, 51 percent constitutes accumulated direct advances from the NBE, and 37 percent is T-bill holdings (figure B1.3.4).

Figure B1.3.4 Stock of Government Domestic Debt



Sources Ministry of Finance and Economic Cooperation.

Note GDP = gross domestic product; NBE = National Bank of Ethiopia.

Domestic financing of the government is one of the areas that the government intends to look into in its current reform agenda. The government's current financing model contributes to financial repression, which greatly hinders the development of a vibrant financial market. Moving away from the existing distortionary financing mechanisms toward a more market-based means of financing will make significant contributions to the development of the financial sector. However, as the government's financing needs have grown significantly over the years, an immediate shift to market-based financing mechanisms poses the risk of facing very high borrowing costs for the government. Thus, the shift needs to be gradual. In this regard, starting to issue T-bills based on market rates (for example, through auctions) only for a small portion of the financing needs initially could be a good starting point. Then, the government can gradually increase the portion of its

financing raised through market-based means, with the aim of eventually phasing out the distortionary financing mechanisms, including direct advances from the NBE.

To have a functioning market for government debt securities, there are also other measures that should be taken. One such measure is revising the directive that forces private commercial banks to divert 27 percent of their fresh loan disbursements for the purchase NBE bills at a low interest rate. Although immediately eliminating this requirement might create liquidity management challenges for the NBE, gradually phasing out the requirement is essential, so that private commercial banks will have sufficient liquidity to be active participants in the government's securities market. In addition, it might also be worthwhile to look into the establishment proclamations of the social security funds in a way that could broaden their investment options.

Fiscal Policy in Ethiopia

The federal government continued to adhere to a cautious fiscal policy stance in FY2018. According to official data, the federal government's fiscal deficit stood at 3.0 percent of GDP in FY2018, which was lower than its level in FY2017 (3.4 percent of GDP) (figure 1.11). The deficit declined following a drop in expenditure and revenue collection.

Revenue growth slowed in FY2018. Due to weak tax administration, generous tax incentives and exemptions, and the disruptive impact of

recent social unrest, all sources of fiscal revenue (direct taxes, indirect taxes, domestic taxes, and foreign taxes) decreased in real terms and as a share of GDP. Total revenue was 13 percent lower than budgeted in FY2018. Hence, the tax-to-GDP ratio declined from nearly 12 percent in FY2017 to 10.7 percent in FY2018. This puts Ethiopia in the bottom third of Sub-Saharan African countries in terms of tax effort.² Revenues and grants dropped from 14.7 percent of GDP in FY2017 to 13.1 percent of GDP in FY2018, mainly due to underperformance in tax revenue collection

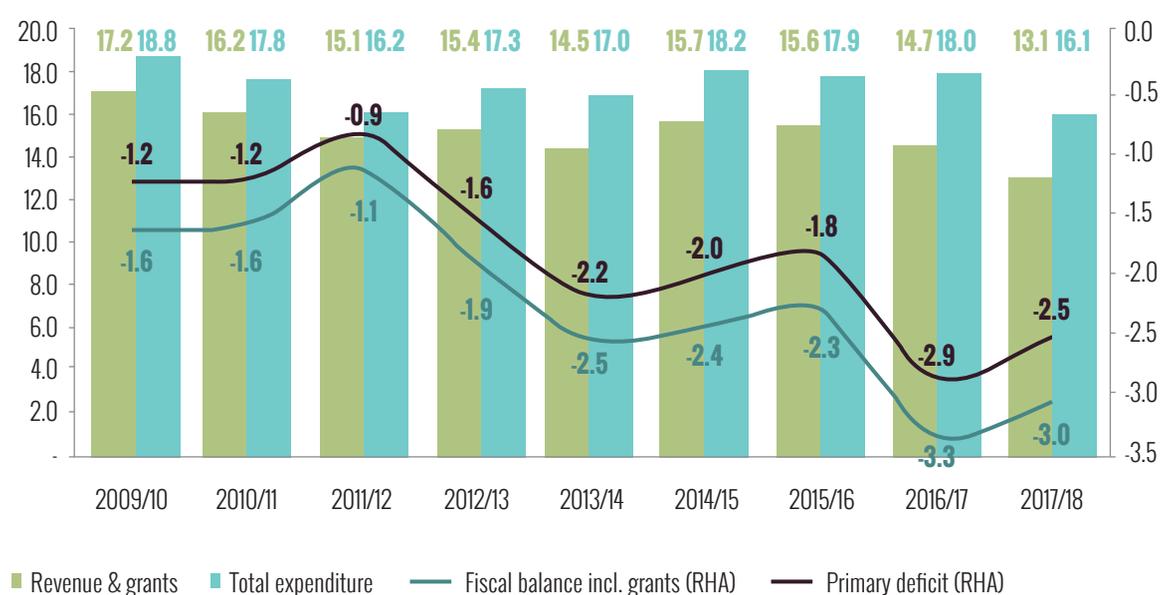
² The average tax-to-GDP ratio for Sub-Saharan Africa was 16.2 percent in 2015 (IMF 2018a).



(figure 1.12). Total revenue fell to its lowest level in more than a decade, reaching 13.0 percent of GDP. Tax revenue fell from 11.7 percent of GDP in FY2017 to 10.7 percent of GDP in FY2018, mainly due to the decline in indirect taxes, the largest source of tax revenue in Ethiopia. Domestic indirect taxes fell from 3.4 percent of GDP in FY2017 to 3.0 percent of GDP in FY2018, and foreign trade taxes dropped to 3.2 percent of GDP in FY2018. The weak performance in domestic indirect taxes could be attributed to inefficiencies in tax administration and low compliance due

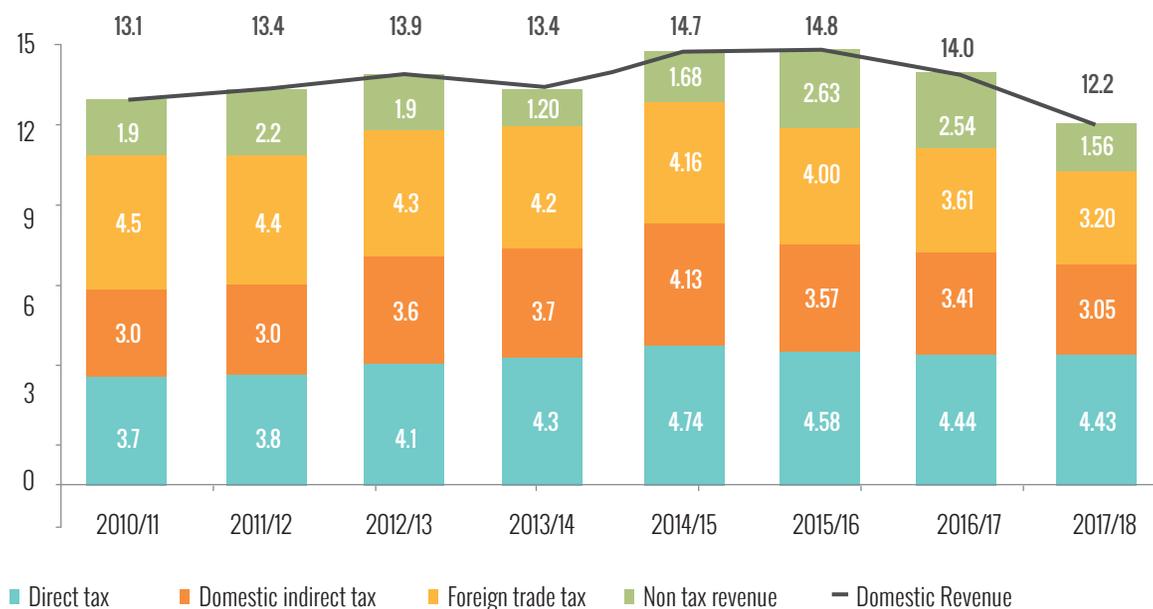
to unrest in the first half of FY2018. Currently, various studies, including by the World Bank, focus on improving tax administration efficiency and increasing tax collection. Tax revenue could be increased from the current level of 11 percent of GDP through reforming the existing tax system and improving the efficiency of tax administration. As the average tax gap (tax potential) for most Sub-Saharan African countries (including Ethiopia) falls between 3 and 5 percent of GDP, addressing inefficiencies appears to be a priority for domestic resource mobilization (IMF 2018a).

Figure 1.11. Government Spending Moderated



Source Ministry of Finance and Economic Cooperation.

Figure 1.12. Revenue Growth Remains Weak
(percent of GDP)



Source Ministry of Finance and Economic Cooperation.

With revenue mobilization underperforming in FY2018, expenditure cuts helped maintain the deficit within reasonable margins, but general government spending increased, driven by increases in recurrent expenditures. Total expenditure fell from 18.0 percent of GDP in FY2017 to 16.1 percent of GDP in FY2018 (figure 1.12). However, despite a decline in capital expenditures by 1.8 percentage points in percent of GDP, recurrent expenditures increased by 19 percent (year-on-year) in FY2018 (keeping the recurrent expenditure stable as a percentage of GDP), mainly due to growth in interest payments and charges, which increased by about 40 percent. The decline in capital expenditure is attributable to a slowdown in development expenditure, which fell by 9 percent in FY2018 compared with FY2017. The low revenue performance impacted government expenditure. Year-on-year capital expenditure growth declined by 6 percent. Thus, the FY2018 fiscal deficit remained within the target anticipated in the annual budget. External, largely

concessional borrowing financed one-third of the fiscal deficit, while domestic borrowing, including direct advances from the NBE equal to 1.1 percent of GDP, financed the remaining two-thirds.

The overall public sector deficit (including SOEs) was further consolidated in FY2018.

The overall public sector primary deficit is estimated at 6.7 percent of GDP in FY2018 (which is nearly the same as FY2017, 6.6 percent of GDP). This shows that the financing needs of the nonfinancial public sector continued to decline, following the government's effort to refrain from nonconcessional borrowing by SOEs. Yet, a complete picture of the public sector is difficult to establish, as the government does not publish consolidated fiscal accounts that include all SOEs.

On January 18, 2018, the government approved a supplementary budget of Birr 14 billion (US\$514.7 million), equivalent to 0.6 percent of GDP. The supplementary budget

was introduced to finance (i) rehabilitation of people affected by conflicts and natural disasters, (ii) student enrollment in the 11 newly opened universities, (iii) transition of the state broadcaster to digitalization, and (iv) the Youth Revolving Fund (box 1.4).

Box 1.4

Why the Supplementary Budget?

Program budgeting and more broadly performance budgeting has a long history across the globe. Many governments have implemented similar reforms, with varied experiences. The program concept is flexible in scope, but it can serve multiple objectives. The program can be a means to enable more efficient use of resources within the program, by aggregating activity budgets and providing more flexibility to program managers to apply these resources during the year. And it can be a vehicle for reorganizing administrative units into more coherent structures focused on objectives.

Analytically, the program can be a means to group inputs around objectives and evaluate effectiveness and efficiency in combination with output and performance data.

In view of the importance of program budgeting, the Ministry of Finance and Economic Cooperation prepared the Program Budget Manual (2010). The manual states that *“although planning and budget process should be thorough and attempt to anticipate the needs of the next year, not all future circumstances can be foreseen with accuracy.”* As a result, it allows two types of budget adjustments:

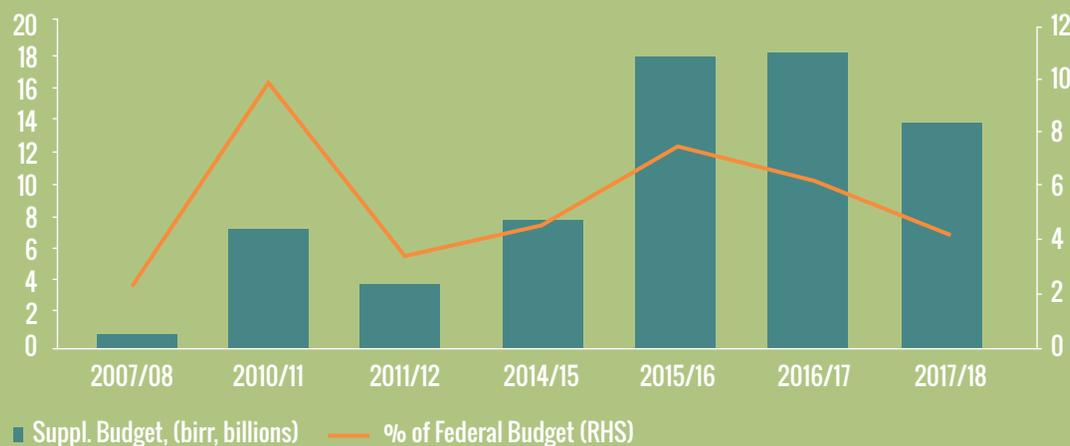
- 1 Budget transfer: moving budget funds between public bodies, budget institutions, projects, or items of expenditure, without changing the total approved budget.
- 2 Budget supplement: the total approved budget can be increased with the approval of the House of People’s Representatives on the recommendation of the Council of Ministers.
The manual states the conditions for the approval of the supplementary budget as follows. During a budget year, while an approved budget is in the process of implementation, it is possible that:
 - a. An unforeseen or urgent need for increased expenditure arises (for example, a natural disaster)
 - b. A new project, not included in the original approved budget, is approved for commencement during the budget year
 - c. Additional resources become available (for example, from external assistance or loans) that can fund increased total expenditure, including any new projects.

Further, Financial Administration Proclamation No. 648/2009 Article 2(12) states that “Supplementary Budget” means a budget approved in situations where the revenue budget appropriated for activities of the government to be carried out in a fiscal year is not sufficient, or where a budget is required for an activity of the government to which budget is not appropriated or where the expenditure budget appropriated for an activity is not sufficient.

With this provision in the Program Budget Manual (MOFED 2010) and Financial Administration Proclamation (2009), alongside the program budgeting it has adopted, the

government has issued supplementary budgets for the past eight years in a row. In the first year after the transition from line-item budgeting to program budgeting, the government approved an additional budget of Br 7.5 billion (10 percent of the total federal budget for that year). For instance, since 2014/15, a supplementary budget equivalent to on average 5.5 percent of the total approved budget has been endorsed each year. The supplementary budget for 2017/18, Br 14 billion, amounts to 4.3 percent of the annual budget approved in June 2017, which is lower compared with the preceding two fiscal years, 6.2 percent in 2014/15 and 7.6 percent in 2015/16 (figure B1.4.1).

Figure B1.4.1 Supplementary Budget and Its Share of the Total Annual Budget



Source: Negarit Gazzetta Budget Proclamations, various years.

Total public spending increased in FY2018.

In the absence of consistent and comprehensive fiscal reports encompassing all extra-budgetary accounts and SOE operations,³ the overall fiscal policy impulse of the public sector cannot be precisely estimated. However, available data indicate a major stimulus effort by the broader

public sector in FY2018. According to the NBE monetary survey, the two state-owned banks, Commercial Bank of Ethiopia and Development Bank of Ethiopia, disbursed 61 percent of all new loans from the banking system in FY2018. The government continued to require that private banks purchase NBE bills equivalent to 27 percent

of their loan portfolios to finance the public sector. As a result, SOEs received 43.7 percent of all new loans disbursed by the banking system in FY2018, up from 39.7 percent in FY2017. Support to SOEs represented 83 percent of the total change in loan disbursement, up from just 12 percent in FY2017. SOEs in the manufacturing, export, transport, communications, mines, power, and water sectors were the main beneficiaries of new loans.

Although the federal government has maintained financial discipline, the broader public sector shows serious financial vulnerabilities.

The government's mix of fiscal, monetary, exchange rate, and structural policies has generated persistent inflation, overvaluation of the birr, large external current account imbalances, foreign exchange shortages, and an elevated risk of debt distress. Although the rapid expansion of public infrastructure investment has boosted firm productivity, this approach is reaching its limit in terms of external debt sustainability and crowding out 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, which is not expected to self-correct in the near term. All three major credit rating agencies assigned Ethiopia a single B-rating, as the country's obligations are considered speculative and subject to high credit risk.

Ethiopia's overall public debt showed an increase in FY2018 but moderated in the first quarter of FY2019. Public debt moderated in the first quarter of FY2019, declining from 57

percent of GDP in June 2018 to 54 percent. External debt⁴ decreased from 29.2 percent of GDP to 27.8 percent, while domestic public debt decreased from 27.8 to 26.1 percent of GDP between June and September 2018. In FY2018, public debt as a percentage of GDP increased to 57 percent compared with 54.9 percent in FY2017 (figure 1.13). The increase was mainly driven by external debt, which increased from 27.5 to 29.2 percent of GDP, while domestic debt marginally increased, from 27.4 to 27.8 percent of GDP. Borrowing from multilateral institutions (largely on concessional terms) accounted for over half of the increase in external debt, while about one-third of the increase came from borrowing from commercial banks. The composition of public debt remained largely unchanged, with a 55:45 ratio between external and domestic debt.

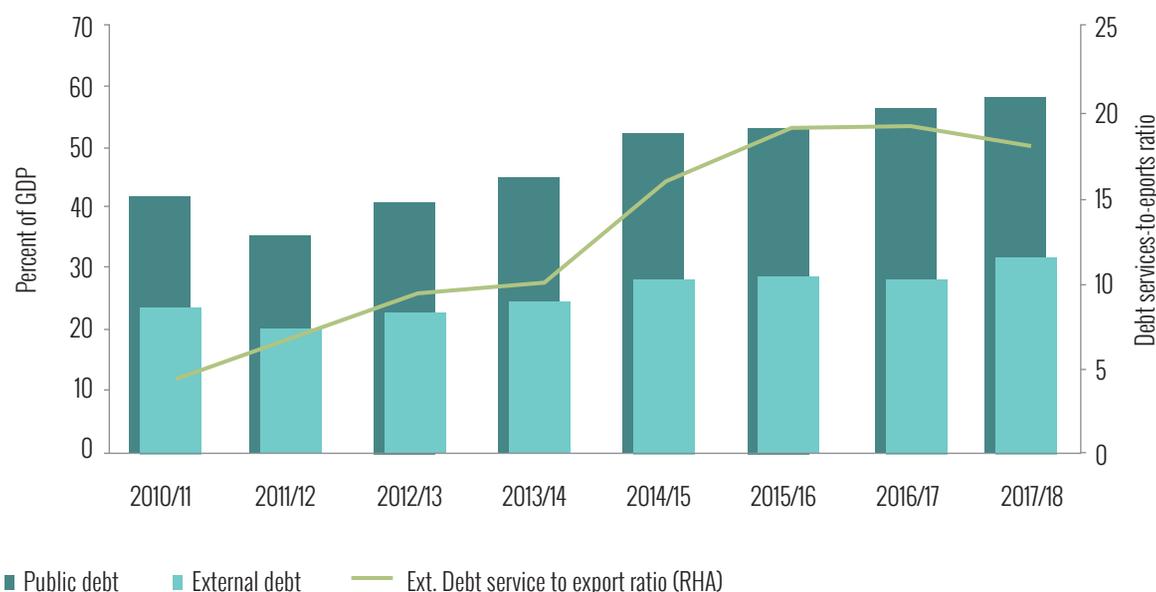
Despite the increase in the level of external debt, debt service expenditures moderated in FY2018, although they remained high.

External debt service payments as a ratio of exports declined to 18.7 percent, from 21 percent in FY2017, as a result of strong export performance (which was entirely attributable to service exports). Notwithstanding the strong service export performance in FY2018, Ethiopia's external debt vulnerabilities mainly arise from lower-than-expected outturns from the export sector. In the 2018 Debt Sustainability Analysis (DSA), the two indicators related to exports—the present value of public and publicly guaranteed external debt-to-exports and external debt service-to-exports—remained above their respective thresholds in the baseline. As a result, the 2018 DSA maintained that Ethiopia remains at “high risk” of external debt distress, as was the case in the 2017 DSA.

³ Adopting international best practices for government finance statistics remains an urgent priority.

⁴ External debt includes Saudi and United Arab Emirates deposits at the NBE but excludes Ethiopian Airlines debt.

Figure 1.13. Public Debt, FY2018



Source Ministry of Finance and Economic Cooperation Debt Bulletin.

The government has taken several steps to address external debt sustainability challenges, including exercising stronger controls on nonconcessional borrowing by SOEs. Ethiopia has put in place a legal debt management framework that is comprehensive and ranks among the best performing countries in the World Bank's Debt Management Performance Assessment. The FY2017 Public Debt Management and Guarantee Issuance Directive was effectively implemented in FY2018. The directive establishes stricter controls by the Ministry of Finance and Economic Cooperation (MOFEC) on the contracting of new nonconcessional borrowing by SOEs. It considerably strengthened MOFEC's monitoring of the FY2018 Budget Law and controls over import-intensive investment projects financed on nonconcessional borrowing terms, including by SOEs.

Tightening of nonconcessional borrowing. The government has tightened control over nonconcessional borrowing. The level of

nonconcessional borrowing decreased from US\$5.8 billion (9 percent of GDP) in FY2015 and US\$2.2 billion (3 percent of GDP) in FY2014 to US\$0.6 billion (0.7 percent of GDP) in FY2018. In addition, the implementation of the FY2017 Public Debt Management and Guarantee Issuance Directive establishes strict oversight by MOFEC of new nonconcessional borrowing by SOEs. MOFEC is also tasked with monitoring compliance with the FY2018 Budget Law and controlling import-intensive investment projects financed on nonconcessional terms. The government is taking proactive steps to renegotiate the terms on the stock of nonconcessional debt.

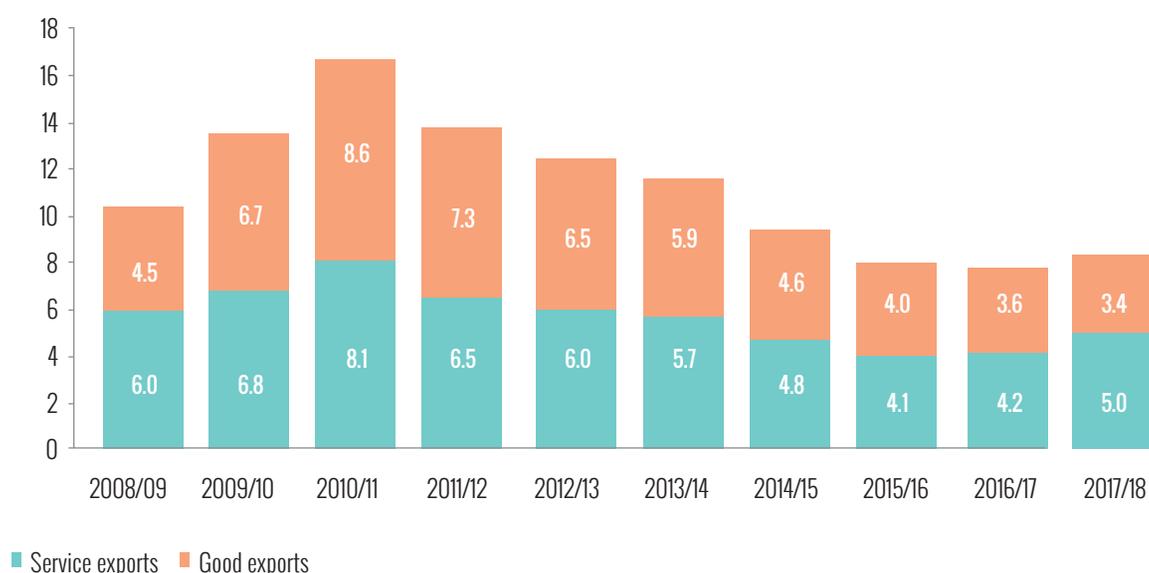
Ethiopia's External Sector

Following an increase of 13 percent in FY2018, total exports continued to expand by 18 percent in the first half of FY2019, driven by services. Led by the performance of Ethiopian Airlines, service exports increased by 41 percent during the first half of FY2019 compared

with the same period in FY2018. In contrast, merchandise exports decreased by 10 percent, reflecting the continued poor performance of Ethiopia's major export items, including coffee, oilseeds, and pulses. Manufacturing export performance was relatively strong, with exports of textiles and electronics posting growth rates of more than 35 percent. Despite these positive developments, total exports do not exceed 10 percent of GDP, significantly below the 24 percent expected from a country the size of Ethiopia at this level of development.

Total exports increased in FY2018, thanks to the good performance of service exports (figure 1.14). Despite the underperformance of goods exports, mainly due to structural and competitiveness issues, such as rigid labor and product markets including an overvalued exchange rate, Ethiopia's total exports expanded by 13.1 percent in FY2018, after years of underperformance. This sharp recovery in exports was driven by growth in service exports, which accounted for half of total exports and expanded by 26.6 percent, mainly due to the strong performance of Ethiopian Airlines.

Figure 1.14. Exports of Goods and Services
(percent of GDP)



Source National Bank of Ethiopia.

Goods exports declined due to the weak performance of coffee. Coffee represented 30 percent of goods exports and decreased by 5 percent in FY2018, 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 FY2018. A closer look at firm-level data reveals that in 2016 exporting firms represented less than 4.5 percent of total manufacturing firms (figure 1.15). Exports accounted for about 2.7 percent of total manufacturing production (figure 1.16). In 2017, industrial parks accounted for 2.4 percent of total exports.

Figure 1.15. Number of Firms

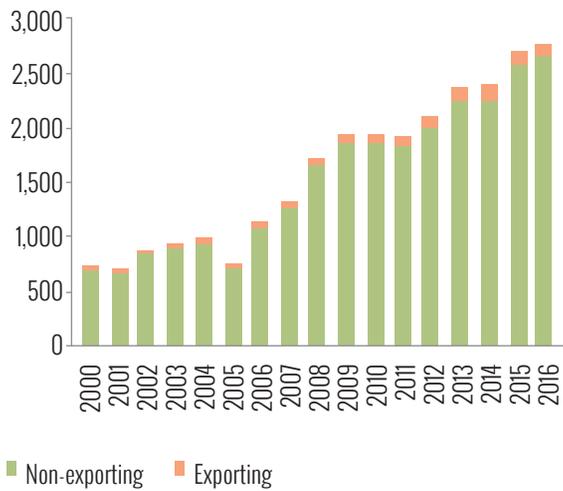
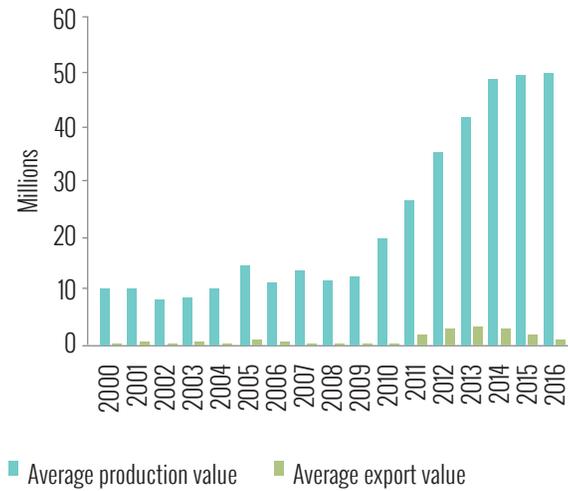


Figure 1.16. Average Production and Exports

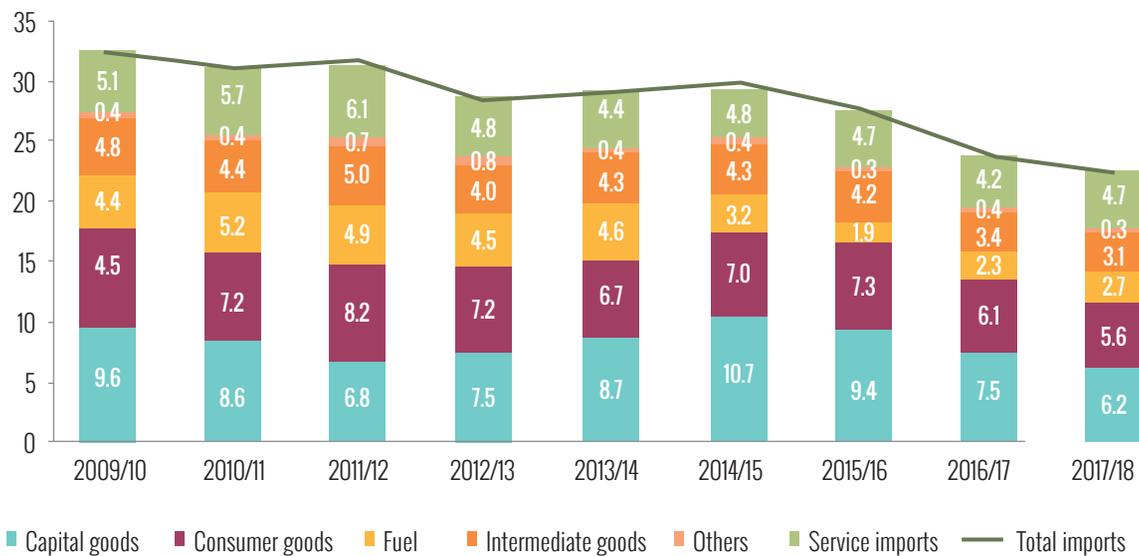


Source Ethiopian Revenue and Customs Authority.

The compression of goods imports played an important role in reducing the current account deficit (figures 1.17 and 1.18). Low levels of exports resulted in liquidity constraints related to

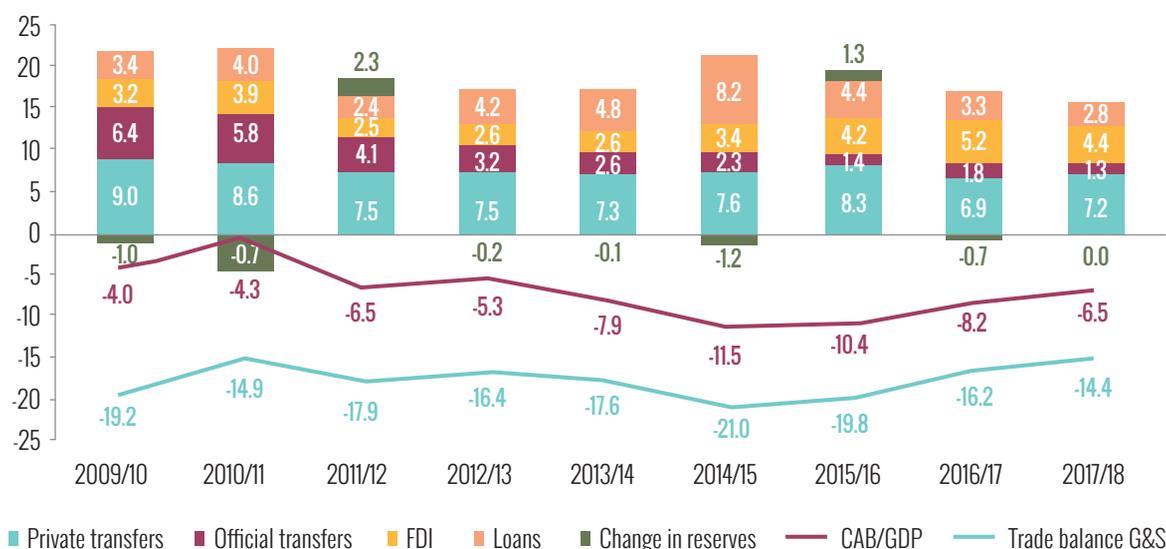
debt service obligations, despite the overall relatively low external debt-to-GDP ratio of 32 percent. Over the medium term, expansion of exports is critical for Ethiopia’s external debt sustainability.

Figure 1.17. Imports of Goods
(percent of gross domestic product)



Source National Bank of Ethiopia.

Figure 1.18. Balance of Payments
(percent of GDP)



Sources National Bank of Ethiopia.

Note CAB = current account balance; FDI = foreign direct investment; G&S = goods and services; GDP = gross domestic product.

Challenges to exports range from supply issues and quality of products, to marketing channels, branding, and so forth. The business environment seems to favor incumbent firms and deter new entrants to export businesses. The export sector lacks dynamism in firm entry and exit. Other factors, such as low entrepreneurship and low regulatory quality for promoting the private sector, may also explain Ethiopia's poor export performance.

After keeping the exchange rate largely constant in FY2018, following the October 2017 devaluation, the NBE resumed its policy of gradual depreciation of the birr against the U.S. dollar in FY2019 (figure 1.19). Following the 15 percent one-off devaluation in October 2017, the nominal exchange rate was kept largely constant for the remaining period of FY2018. The official exchange rate against the U.S. dollar depreciated by less than 1 percent between October 2017 and June 2018. The NBE

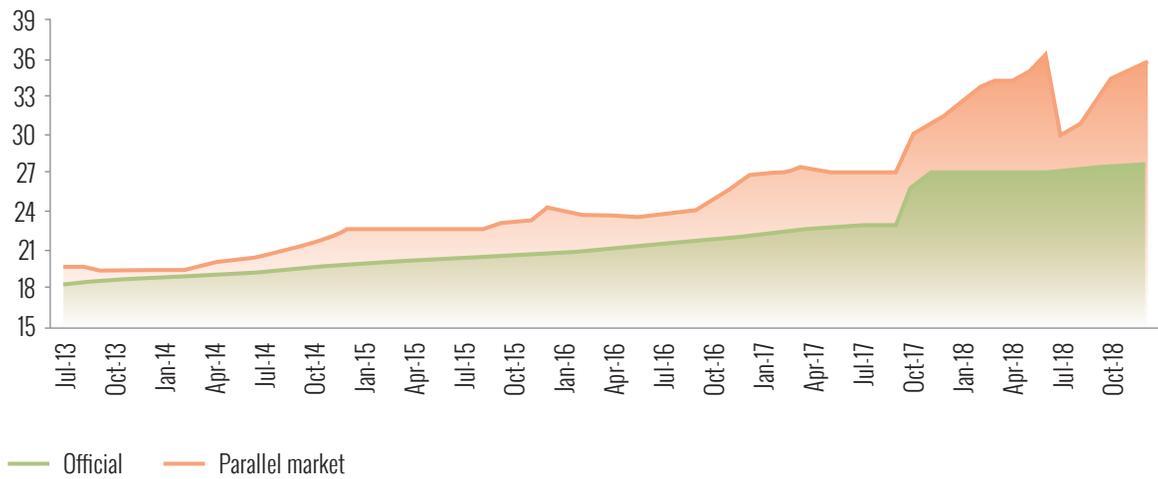
allowed the birr to depreciate by about 2.9 percent against the U.S. dollar during the first six months of FY2019. The premium between the official and parallel market exchange rates widened in FY2018, reaching a peak of about 30 percent toward the end of the fiscal year. However, there was a sharp narrowing of the premium in June/July (reaching about 5 percent), following the government's call for the public to exchange foreign currency holdings in commercial banks. The premium has again started to widen in recent months, returning to its previous level of about 30 percent.

The real effective exchange rate (REER) depreciated by 7.1 percent in FY2018, reversing the appreciating trends of the past six years, although the appreciating trend has resumed in recent months (figure 1.20). The depreciation of the REER was largely owing to the 15 percent one-off devaluation of the nominal exchange rate of the birr against the U.S. dollar in October 2017. However, the trend has

reversed in recent months, with the REER showing a quarter-on-quarter appreciation of 4.8 percent in the first quarter of FY2019, as the inflation differential with trading partners remains high.

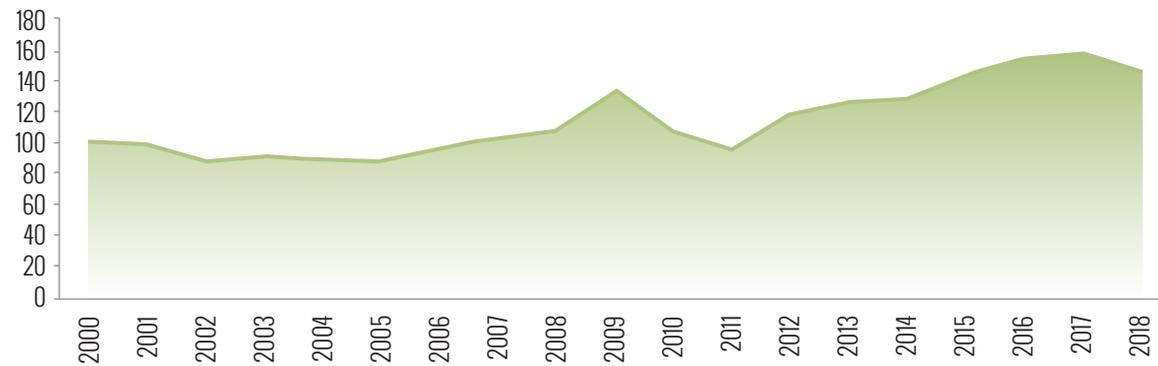
According to the International Monetary Fund's estimates, the REER was overvalued by 12-18 percent in September 2018 (IMF's Article IV Consultation Report, 2018).

Figure 1.19. Nominal Exchange Rate of the Birr against the U.S. Dollar



Source National Bank of Ethiopia.

Figure 1.20. Real Effective Exchange Rate Index (2000 = 100)



Source National Bank of Ethiopia.

Currently, the focus seems to be on large foreign direct investment (FDI) and state-owned firms, without commensurate attention to the role of the domestic private

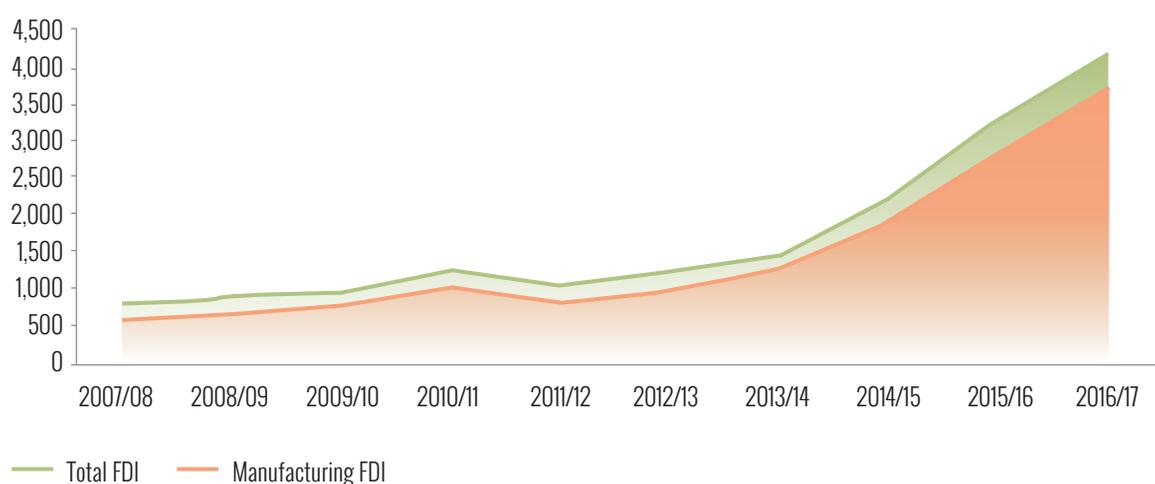
sector in manufacturing. Although FDI inflows to the manufacturing sector are growing, partly due to the establishment of industrial parks, the total FDI stock remains small, but it has grown

overtime. FDI inflows to the manufacturing sector constituted more than 80 percent of total FDI inflows over the past 10 years (figure 1.21). However, it is yet to be seen whether multinational companies will have a positive spillover effect on the productivity of local firms, as the multinational companies tend to be confined to industrial zones where only a few domestic firms are located. Interviews with Ethiopian exporters brought up two recurrent themes: constraints on accessing foreign exchange, which impede the imports of intermediate inputs required for export-oriented production (especially for non-endowment firms situated outside industrial parks) and high turnover of the labor force (especially for firms established in industrial parks). The interviews also raised several well-known challenges linked to

bottlenecks in transport and telecommunications infrastructure, human capital shortages, erratic policy changes, and political favoritism.

The Ethiopian authorities are aware of these features of their economy, and efforts at diversifying and increasing exports are ongoing. For example, to support exports and encourage the private sector, on October 10, 2017, the NBE devalued the birr by 15 percent and relaxed foreign exchange controls.⁵ The new leadership seems to be committed to pursuing reforms that improve the country's export performance. For such efforts to be effective, including for poverty reduction (Box 1.5), it is important to understand the main impediments to export growth and diversification.

Figure 1.21. Share of Manufacturing FDI in Total FDI, 2007/08–2016/17
(U.S. dollars, millions)



Sources Ethiopian Investment Commission.

Note FDI = foreign direct investment.

⁵ Foreign exchange controls were relaxed with the issuance in October of two NBE directives on (i) external loans and suppliers' credit, and (ii) retention and utilization of export earnings and inward remittances. Under the first directive, any domestic investor can now access an external loan, if the investor generates foreign currency. The debt-equity ratio to access a loan from foreign sources has been revised to 60-40, replacing the hitherto 50-50 ratio. Under the second directive, exporters of goods and services are authorized to retain 30 percent of the proceeds of their exports indefinitely in their forex account (replacing the previous 10 percent threshold).

Box 1.**Trade and Poverty Reduction in Ethiopia**

The expansion of international trade has been essential for development and poverty reduction. Trade as a proportion of global gross domestic product has approximately doubled since 1975. But trade is not an end in itself. People measure the value of trade by the extent to which it delivers better livelihoods, through higher incomes, greater choice, and a more sustainable future, among other benefits. The number of people living in extreme poverty around the world has fallen by around one billion since 1990. Without the growing participation of developing countries in international trade, and sustained efforts to lower barriers to the integration of markets, it is difficult to see how this reduction could have been achieved.

By lowering trade costs for deeper integration of markets and improving the enabling environment, trade can play a key role in poverty reduction in Ethiopia. For example, a recent study suggests that the gains from trade in remote regions of Ethiopia tend to be captured by intermediaries, thus highlighting the importance of reducing transaction costs and intensifying the poverty impact of integration policies to ensure that the rural poor benefit from trade.

By effectively using technology, trade can help link producers to upstream buyers and

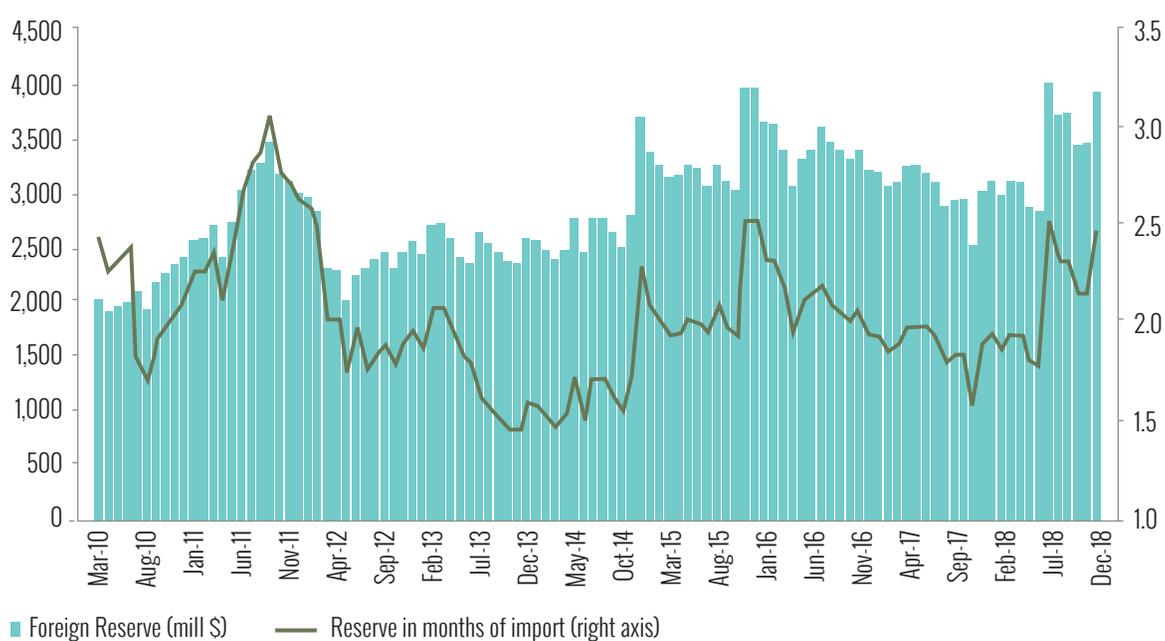
mitigate the risks faced by the poor. For instance, agricultural commodity exchanges can improve farmers' understanding of market conditions and enable them to receive better prices for their crops. All coffee and sesame products from Ethiopia that are not directly exported by farmers are traded at the Ethiopian Commodity Exchange (ECX) by law. The ECX reaches 2.4 million small farmers through farmer cooperative unions, which are members of the ECX. By effectively using mobile technology, agricultural commodity exchanges can become a platform where farmers can receive up-to-date market information and help them optimize decisions related to the sale of their produce. Kenya's Agricultural Commodities Exchange, which deals with nontraditional export commodities, such as maize and beans, conveys daily information on the prices of some 20 commodities collected from market vendors around the country to farmers and market intermediaries, such as traders, through SMS text messages and daily radio bulletins. Similarly, the ECX provides market data in various ways, including to rural ticker boards. Expanding and improving the use of this system can lead to significantly increased income through better access to information and services in Ethiopia: 75 percent of farmers reported higher income as a result of Kenya's Agricultural Commodities Exchange.

Source World Bank and WTO (2017).

Gross foreign exchange reserves remained low, at US\$2.85 billion at end the of FY2018 (figure 1.22). 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 (DSAs), the Ethiopia's external position is weaker than warranted by fundamentals.

Figure 1.22. Gross Official Foreign Exchange Reserves (US\$, millions)



Source National Bank of Ethiopia.

1.3. Ethiopia's Economic Prospects in FY2019 and Beyond

The economic prospects for FY2019 and the medium term are expected to remain stable. The current reform agenda envisaging a greater role for the private sector aims to support growth. Annual real GDP growth is projected to be around 7.9 percent in FY2019 and 8.2 percent in the medium term (table 1.1). The reform agenda proposed by the new prime minister is expected to address some macroeconomic

imbalances, while moderate fiscal deficits and prudent monetary policy are expected to reduce the rate of inflation and keep it in the single digits. Merchandise exports could recover in the medium term, as large investment projects, such as the railway to the Port of Djibouti and large power dams (with potential for electricity exports), become operational.

On the supply side, growth in all sectors is projected to be robust. Agriculture is projected to continue growing at about 4 percent, as national main season crop production for 2018/19 is expected to be average, following forecasts of average rainfall during the main (*meher*) and *belg* seasons. Localized areas in the northeastern and eastern parts of the country may face below-average seasonal rainfalls (FEWS NET 2018). Industrial growth is expected to decline slightly in FY2019, to about 11 percent. The service sector is projected to continue expanding, due to the spillover effects from growth in other sectors.

In line with the government's reform, the private sector is expected to play an active role. Private investment is projected to increase by 10.6 percent, while government investment (public investment) is expected to decelerate. Household and government consumption are projected to decelerate temporarily. Although the general government fiscal policy stance is expected to remain relatively cautious (the FY2019 budget does not allow for any new investment projects), domestic revenue may be insufficient to finance the infrastructure investments foreseen in the national development plan, which will require public-private partnerships.

The federal government approved the FY2019 budget with a deficit targeted at 3.3 percent of GDP. Although the deficit targeted for FY2019 is higher than the fiscal deficit for FY2018, the FY2019 budget assumes a significant improvement in revenue collection while maintaining expenditures, especially capital expenditures, at the FY2018 level. Of the total budget approved for FY2019 (Br 346.9 billion), 26.4 percent is allocated to recurrent expenditure, 32.8 percent to capital expenditure, and 39 percent to regional transfers. Sixty-six percent of the budget is allocated to pro-poor expenditures focusing on education, health, industrial development, and the Urban Productive Safety Net.

The government is expected to continue its cautious fiscal policy stance. Government revenue is projected to increase gradually, following tax reforms and improvements in tax compliance, while government expenditure, mainly capital expenditure, is expected to stabilize. As a result, the fiscal deficit would remain at the 3 percent observed in FY2019 and further improve to reach 2.9 percent in FY2020.



Table 1.1: Ethiopia: Macro poverty outlook indicators
(annual percent changes unless indicated otherwise)

	2015	2016	2017	2018	2019f	2020f	2021f
Real GDP growth, at constant market prices	10.4	7.6	9.5	8.0	7.9	8.2	8.3
Private consumption	9.9	1.8	5.0	4.9	4.0	4.8	5.0
Government consumption	3.8	13.3	20.4	26.4	9.7	7.0	6.9
Gross fixed capital investment	26.2	10.6	12.4	0.8	10.2	10.5	10.5
Exports, goods and services	-11.2	-8.1	7.4	8.3	7.5	8.0	8.3
Imports, goods and services	21.9	0.0	-5.1	1.5	1.8	2.0	2.0
Real GDP growth, at constant factor prices	10.9	9.2	10.2	7.7	7.9	8.2	8.3
Agriculture	6.4	2.6	6.7	3.5	4.0	4.5	5.0
Industry	19.8	22.8	18.7	12.2	11.0	11.0	11.5
Services	11.1	8.6	8.3	8.7	9.3	9.4	8.7
Inflation (Consumer Price Index)	10.1	7.3	7.1	13.1	9.0	8.0	8.0
Current account balance (% of GDP)	-11.9	-10.2	-8.2	-6.5	-6.2	-5.9	-5.3
Fiscal balance (% of GDP)	-2.4	-2.3	-3.2	-3.0	-3.0	-2.9	-3.0
Debt (% of GDP)	54.0	55.0	57.7	58.7	57.9	62.9	62.0
Primary balance (% of GDP)	-2.0	-1.9	-2.7	-2.5	-2.4	-2.3	-2.3
International poverty rate (\$1.9 in 2011 PPP) ^{a, b}	27.3	26.5	25.2	24.2	23.2	22.2	21.3
Lower middle-income poverty rate (\$3.2 in 2011 PPP) ^{a, b}	62.2	61.3	60.0	58.8	57.7	56.7	55.6
Upper middle-income poverty rate (\$5.5 in 2011 PPP) ^{a, b}	85.0	83.8	82.0	80.4	78.9	77.4	76.0

Sources World Bank staff estimates.

Note GDP = gross domestic product; PPP = purchasing power parity.

Poverty is expected to continue its steady decline on the back of sustained strong growth. Good rains in 2018 in most parts of the country boosted the small *belg* harvest and are expected to result in a better-than-average

main *meher* harvest, benefiting rural producers and easing urban food inflation. Based on past elasticities, poverty measured by the international poverty line is expected to decrease to 22 percent by 2020.

Risks and Challenges

The medium-term sustainability of the growth model poses an important risk.

The key economic challenge relates to limited competitiveness, which may constrain the development of manufacturing, creation of jobs, and increase of exports. The pursuit of sound, private sector-led and export-oriented economic policies is therefore critical for achieving Ethiopia's economic and social ambitions.

Rising external imbalances constitute major challenges to the economy. The lack of external openness, rising international oil prices, and an overvalued exchange rate (even after the 2017

devaluation) will continue to have adverse effects on competitiveness, affecting short-to-medium-term growth. The rising risk to external debt sustainability may impact Ethiopia's access to external finance.

Political disruption associated with social unrest could derail the new reform agenda

and negatively impact growth through lower FDI, tourism, and exports. The outlook for poverty reduction, while positive, also faces significant downside risks, given continued localized turmoil and large-scale displacement. Ensuring that growth translates into increased opportunities for social and economic advancement for Ethiopia's young and rapidly growing population will be a defining challenge in the coming years.

Box 2.4

How Does Poverty (Reduction) in Ethiopia Compare with Other Countries?

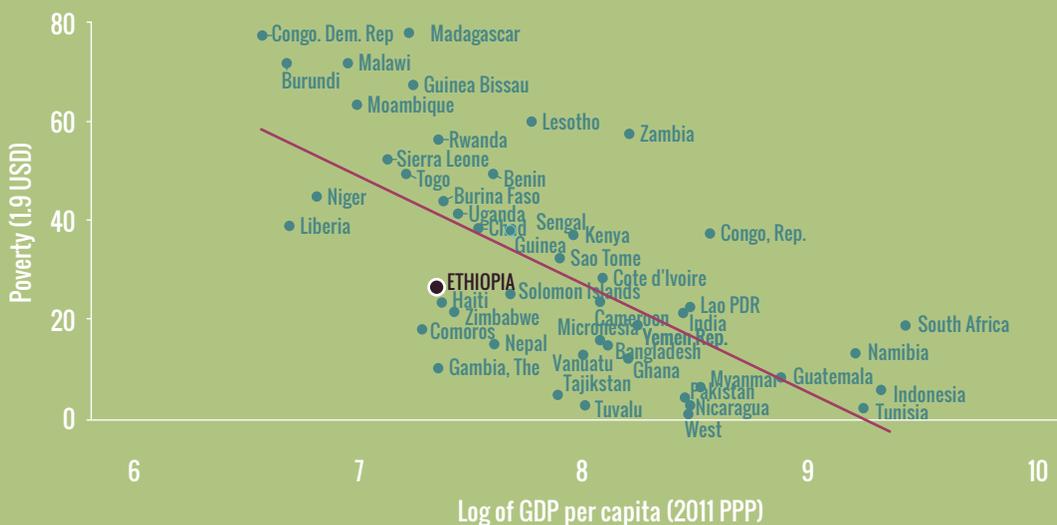
Over the past 10 to 15 years, poverty in Ethiopia has decreased substantially on the back of strong growth. How does the current state of poverty in Ethiopia compare with that of other countries, in a static and dynamic sense? That is, conditional on Ethiopia's level of development, is the country's poverty rate high or low? And has there been "enough" poverty reduction, given the exceptionally strong gross domestic product (GDP) growth? To answer these questions, we use the World Bank's international poverty line of US\$1.9 per capita per day (in purchasing power parity terms) to compare Ethiopia with a selection of other countries.

Although Ethiopia has a relatively low poverty rate for its income level, it also has weak transmission between aggregate growth and poverty reduction. The poverty rate for Ethiopia based on the international

US\$1.9 poverty line amounted to about 27 percent in 2015/16, substantially lower than would be estimated based on its per capita GDP. Countries with similar per capita GDP levels tend to have higher poverty rates (figure B2.4.1). However, the extent to which growth in GDP per capita in Ethiopia translates into poverty reduction has been low: the "poverty-elasticity of growth," a measure of the extent to which GDP growth decreases poverty, amounted to -0.22 between 2005 and 2015. That means that a 1 percent increase in per capita GDP was accompanied with a 0.22 percent decrease in the poverty rate. Among a sample of comparator countries that also had at least two surveys during the same time period (2005–15), only Zambia had a lower responsiveness of poverty to growth (figure B2.4.2). The semi-elasticity, which measures the *percentage point* change in poverty for a 1 percent change in per capita GDP, is similarly low: between 2005 and 2015, a 1 percent

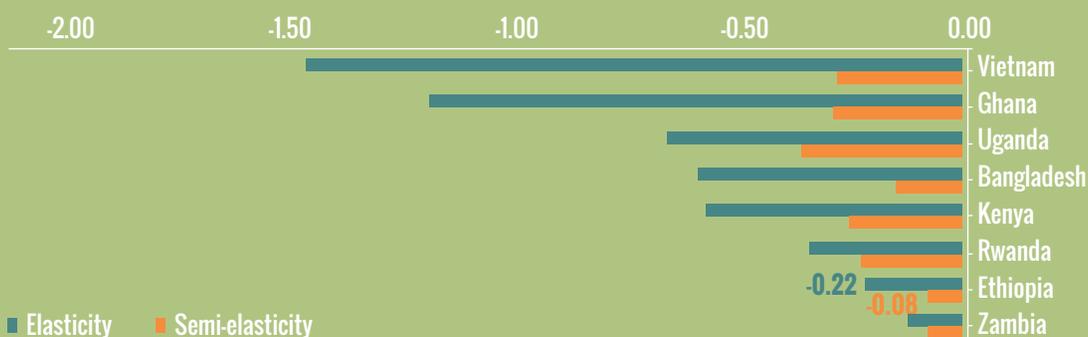
increase in per capita GDP was accompanied by a 0.08 percentage point reduction in poverty.^a Uganda's semi-elasticity, for instance, was four times higher.

Figure B2.4.1 Ethiopia Has a Low Poverty Rate for Its Income Level
(linear association between GDP per capita and international poverty rates)



Sources World Development Indicators 2018; World Bank staff calculations.
 Note The countries included are low- or middle-income countries with at least one poverty survey since 2010.

Figure B2.4.2 But Ethiopia Has Weak Transmission between Growth and Poverty Reduction
(growth-elasticity of poverty, 2005–15)



Sources World Development Indicators 2018; World Bank staff calculations.
 Note The countries included are low- or middle-income countries with at least two poverty surveys between 2005 and 2015.

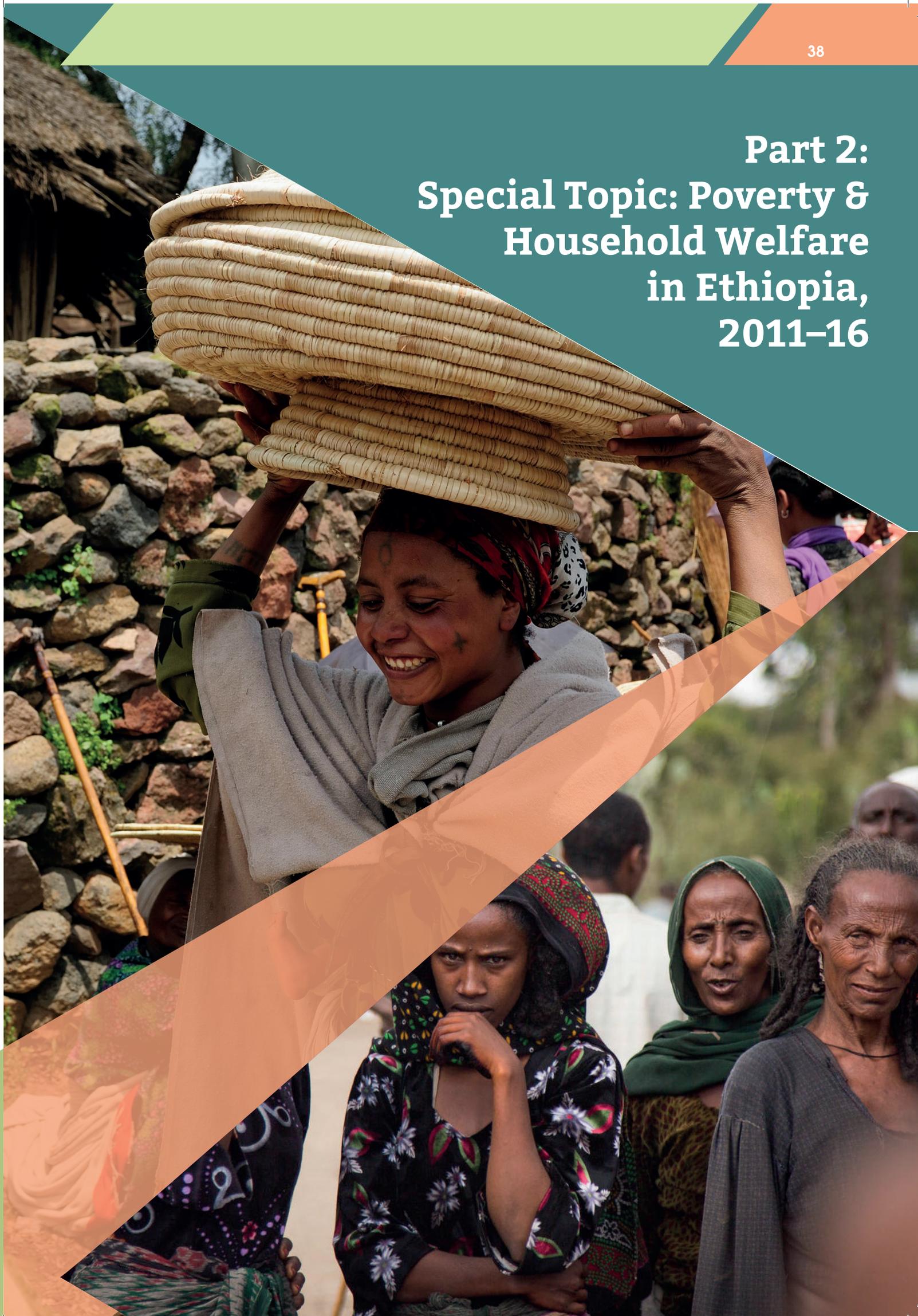
The reasons behind Ethiopia's low conversion rate between growth and poverty reduction are not entirely clear.

Research shows that countries with low levels of initial development (high initial poverty rates) tend to have lower growth-poverty elasticities, as do countries with high levels of inequality (Bourguignon, 2003; Ravallion, 2012). While Ethiopia definitely had low levels of initial development (by far the lowest of the countries included in figure 2.4.1), it also had among the lowest levels of inequality. It is possible that the baseline level of development in Ethiopia was so low that growth has increased incomes of the poor but not yet to the level of pulling them above the poverty line. If that hypothesis

were true, continued economic growth could lead to much more poverty reduction in the future.

a. The growth-elasticity of poverty is notoriously sensitive to the baseline level of development. If initial levels of consumption are low, growth rates of consumption will be relatively high for the same absolute change, which will lead to an underestimation of the growth-elasticity of poverty. As such, growth-elasticities tend to be higher in richer countries. The semi-elasticity partly avoids this pattern and does not automatically increase when a country grows richer (Klasen and Misselhorn 2008).

Part 2: Special Topic: Poverty & Household Welfare in Ethiopia, 2011–16



2.1 Introduction

Poverty in Ethiopia decreased substantially over the past decade, although by less than what would have been expected based the country's on strong economic growth. Despite adverse climatic circumstances linked to the 2015/16 El Niño drought, poverty reduction has continued in recent years. According to the government's Interim Report on 2015/16 Poverty Analysis Study, the share of the population living below the national poverty line decreased from 30 percent in 2011 to 24 percent in 2016 (FDRE 2017).⁶

This special topic complements the government's Interim Report on 2015/16 Poverty Analysis Study, by taking a closer look at some of the household-level welfare trends between 2011 and 2016. Rather than focusing on binary poverty status (whether a household is above or below the poverty line), the analysis focuses on household consumption

expenditures as a proxy for household income.⁷ We draw on the two most recent Household Consumption Expenditure Surveys (HCES), the 2010/11 round and the 2015/16 round. Although the special topic focuses mainly on descriptive trends, the World Bank is currently preparing a deep-dive analysis of poverty and its drivers in Ethiopia for the forthcoming 2019 Poverty Assessment.

The special topic proceeds as follows. The next section sketches the trends in household consumption expenditures between 2011 and 2016, disaggregated by urban/rural location, region, and agro-ecological zone. Section 2.3 discusses the distribution of growth and its implications for the change in inequality. Section 2.4 expands on the situation in terms of monetary living standards for the most recent year for which data are available (2016). Section 2.5 concludes.

2.2 Trends in Household Welfare, 2011–16

This section discusses changes in household consumption expenditures between 2011 and 2016. The analysis mainly focuses on *median* consumption levels rather than means (although *means* are presented in annex A). The median represents the level of consumption below or above which lies the consumption of half the population. In other words, half the population has a consumption level lower than the median, while the other half

has a consumption level above the median. The choice of the median over the mean is because, unlike the mean, the median is not sensitive to extremely high values, which makes the median preferable when the focus is on the living standards of lower-income groups. The median is also more robust to measurement errors in consumption. Box 2.1 explains the construction of the household consumption aggregate.

⁶ The national poverty line was determined at Br 7,184 per adult equivalent per year (in December 2015 prices).

⁷ In countries where regular wage employment is rare and most people make their living from the land or as self-employed workers, consumption is considered a better welfare indicator than income. This is largely because of the difficulty in measuring incomes when income flows are erratic and unpredictable, or when large shares of households do not earn cash income (for instance, pure subsistence farmers) (World Bank 2005).

Box 2.1

Consumption Aggregation and Adjustments

The analysis presented in this Economic Update is based on detailed consumption data included in the Household Consumption Expenditure Surveys (HCES) (2010/11 and 2015/16).

All consumption of food and nonfood items is included, regardless of whether these items are purchased on the market, come from own production, or were received as gifts. For own-consumption and gifts, the quantities consumed are valued at prevailing prices in the enumeration area. Although consumption is expressed on an annual basis, the reference period used during data collection varies based on the nature of the consumption item. For example, information on food and food-related items was asked twice a week using the “last three days” and “last four days” as reference periods (households are visited twice during the HCES). For house rent, durable goods, clothing, health and education expenditures, and so forth, the “last three months” and “last 12 months” were used as references. Imputed rent is included in the consumption aggregate.^a To capture the effect of seasonal variations, the data were collected over a 12-month span (Hamle 1 to Sene 30/July

8 to July 7), by randomly allocating sample households to different months.

To adjust for price variations across time and space, spatial and temporal price deflators are used.

First, nominal consumption is adjusted for price differences across reporting levels, by using the spatial deflators provided by FDRE (2012, 2017). Second, spatially-deflated consumption levels are expressed in December prices (December 2010 and December 2015), by using the food and nonfood Consumer Price Indexes provided by the Central Statistical Agency. The food and nonfood Consumer Price Indexes are also used to bring the December 2010 consumption expenditure (2010/11 HCES) to December 2015 prices. Finally, to adjust for variations in household size and composition, consumption expenditure is divided by the officially-used adult-equivalent scales, which are based on calorie requirements and vary by age and sex. This exercise should result in a consumption aggregate that can be compared through space and time. The consumption aggregates used in this special topic section are the official ones used by the National Planning Commission.

Sources DRE (2012, 2017); Central Statistical Agency 2018.

a. Imputed rent was already included in the HCES data set obtained from the Central Statistical Agency and as such was not calculated by the World Bank.

Strong Consumption Growth in Urban Areas, Relatively Weak in Rural Areas

Overall, solid household consumption growth was observed between 2011 and 2016, particularly in urban areas. At the national level, the median annual consumption per adult increased from Br 9,520 to Br 10,657, a 12 percent increase.⁸ Expressed in U.S. dollars and corrected for differences in the purchasing power of a dollar between Ethiopia and the United States,

the median consumption per adult amounted to US\$1,301 per year in 2015/16.⁹ The increase in consumption was substantially stronger in urban areas, where the median annual consumption per adult increased by 32 percent, from Br 10,750 to Br 14,230.¹⁰ In rural areas, median consumption increased by about 7 percent (from Br 9,331 to Br 9,944). Real consumption levels in 2015/16 were approximately 43 percent higher in urban than in rural areas (figure 2.1). The results are similar if mean consumption is used instead of median consumption (annex A).

Figure 2.1. Consumption Increased between 2011 and 2016, Particularly in Urban Areas (median annual consumption per adult, December 2015 prices)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Consumption increased in all regions except Afar and Amhara. Annual median consumption per adult equivalent decreased from Br 9,031 to Br 8,503 (a fall of 6 percent) in

Afar and from Br 9,395 to Br 9,219 (a decrease of about 2 percent) in Amhara.¹¹ Consumption increased in all the other regions, although the magnitude of the increase varied: the highest

⁸ All consumption values in this and the next section are expressed in December 2015 prices.

⁹ The purchasing power parity conversion factor for private consumption was Br 8.189 for US\$1 in 2015 (World Bank 2018).

¹⁰ This is in line with the National Planning Commission's interim poverty report, which shows that urban poverty decreased by 11 percentage points between 2011 and 2016, compared with 5 percentage points in rural areas (FDRE 2017).

¹¹ The forthcoming Poverty Assessment will examine in detail the drivers of consumption movements between 2011 and 2016. It is possible that the decline in median consumption in Afar and Amhara was related to the El Niño drought. Mean, as opposed to median, consumption increased in all regions, including Afar and Amhara, although not in a statistically significant fashion (see annex A).

increase in median consumption was observed in Harari (49 percent), followed by Dire Dawa (27 percent) and Gambella (25 percent).¹² Urban consumption increased in all regions, but there was large variation in the magnitude: the highest increase happened in Dire Dawa, where consumption increased by 66 percent, followed by

Amhara with a 56 percent rise. The lowest urban consumption increase was observed in Somali (10 percent). Rural consumption levels increased significantly in Tigray, Gambella, and Harari. In the other regions, the change in rural consumption between 2011 and 2016 was not statistically different from zero (table 2.1 and annex A).

Table 2.1: Household Consumption Increased in All Regions Except Afar and Amhara
(regional median annual consumption per adult equivalent, December 2015 birr)

Region	Total			Urban			Rural		
	2011	2016	% change	2011	2016	% change	2011	2016	% change
Tigray	9,308	10,749	15.5	13,786	15,665	13.6	8,604	9,705	12.8
Afar	9,031	8,503	-5.9	11,317	15,339	35.5	8,277	7,892	-4.7
Amhara	9,395	9,219	-1.9	10,289	16,095	56.4	9,301	8,758	-5.8
Oromia	9,748	10,993	12.8	10,758	14,090	31.0	9,615	10,894	13.3
Somali	9,197	10,195	10.9	11,052	12,143	9.9	8,868	10,128	14.2
Benishangul-Gumuz	9,671	10,641	10.0	11,640	14,659	25.9	9,506	9,971	4.9
SNNPR	9,278	9,972	7.5	10,308	14,089	36.7	9,169	9,692	5.7
Gambella	9,134	11,382	24.6	10,304	13,862	34.5	8,837	10,210	15.5
Harari	11,255	16,739	48.7	12,448	18,392	47.8	10,638	15,607	46.7
Addis Ababa	10,377	12,718	22.6	10,377	12,718	22.6	-	-	-
Dire Dawa	9,610	12,203	27.0	9,540	15,876	66.4	9,733	11,280	15.9

Sources Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Note SNNPR = State of Southern Nations, Nationalities, and Peoples' Region.

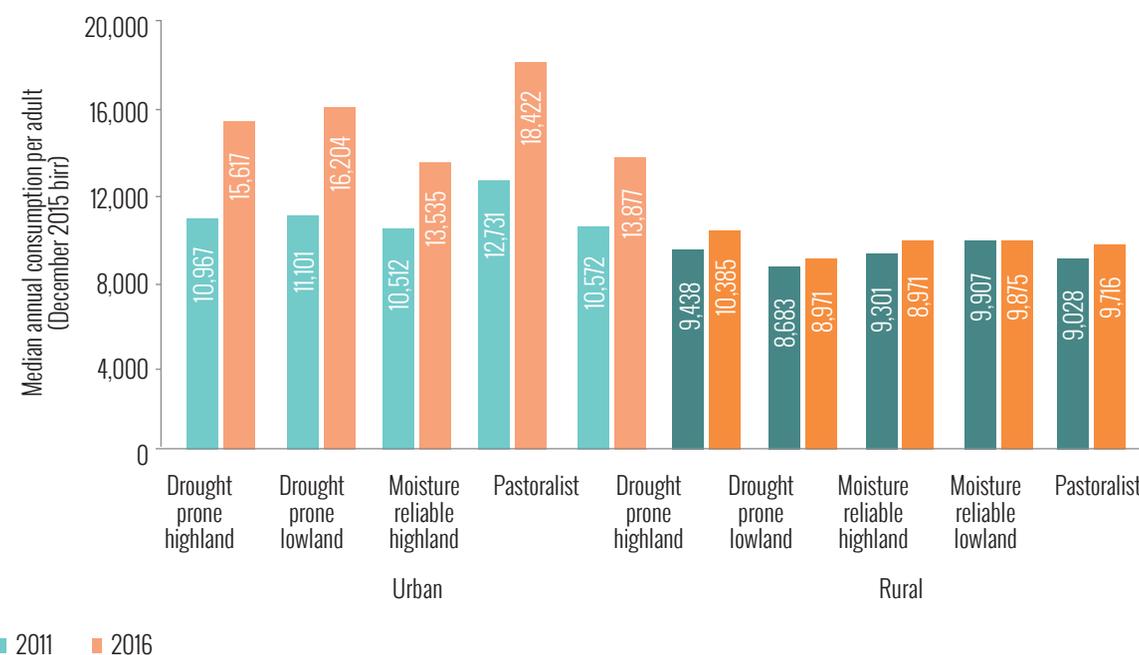
Consumption increased across the major agro-ecological zones in Ethiopia. The agro-ecological zones are based on elevation and rainfall volume and variability and are labeled as (i) moisture-reliable highlands, (ii) drought-prone highlands, (iii) moisture-reliable lowlands, (iv) drought-prone lowlands, and (v) pastoral areas. (map B.1, in annex

B, plots the distribution of the agro-ecological zones.) Urban consumption increased significantly in all five agro-ecological zones. However, in rural areas, consumption increased in the highlands (drought-prone and moisture-reliable) but did not change in a statistically significant fashion in the lowland or pastoral areas (figure 2.2).

¹² Harari and Dire Dawa are predominantly urban, and Addis Ababa is completely urban. The findings are consistent with the higher consumption growth observed in urban areas in general.

¹³ Although overall (urban and rural combined) and urban mean consumption increased in all five agro-ecological zones, rural consumption decreased in the drought-prone lowlands (and increased in the other ecological zones, although the magnitude was small). See annex A.

Figure 2.2. Consumption Increased in All Agro-Ecological Zones, Particularly in Urban Areas (median annual consumption per adult equivalent, December 2015 birr)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Trends in calorie intake roughly conform to the trends in consumption expenditures.

At the national level, the median daily calorie consumption per adult increased from 2,668 to 2,809 kilocalories (kcal) (an increase of 5.3 percent). It increased from 2,518 to 2,666 kcal in urban areas and from 2,725 to 2,831 kcal in rural areas (figure 2.3).¹⁴ There is substantial variation across regions, with median calorie

intake decreasing most notably in the rural areas of Amhara and Benishangul-Gumuz. Looking at agricultural zones, the drought-prone lowlands experienced a significant decrease in calorie intake. Although this may have been a result of the 2015/16 El Niño drought, quantitative research has so far failed to find a clear negative impact of the drought on household-level outcomes (box 2.2).

¹⁴ It may seem counterintuitive that calorie intake is lower in urban than in rural areas. However, the nature of work in rural areas (working the fields) requires a higher intake of calories compared with the nature of most work in urban areas. In addition, urban households tend to consume more expensive sources of calories, such as teff and animal products.

Figure 2.3. Calorie Consumption Showed a Modest Increase between 2011 and 2016 (median daily calorie consumption per adult equivalent)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Box 2.2

The (Non) Impact of the El Niño Drought?

In 2015/16, Ethiopia was hit by the El Niño drought, which was labeled the worst drought in five decades. The failure of two consecutive rainy seasons in 2015 led to a sharp increase in humanitarian requirements, with more than 10 million Ethiopians in need of humanitarian food aid, on top of the chronically food-insecure Productive Safety Net Programme caseload of eight million.^a Government and development partners mounted a large-scale humanitarian response, which was credited with averting any loss of life due to starvation.

Despite the severity of the drought, it is difficult to observe its aggregate effects in official statistics. Chronic malnutrition decreased between 2011 and 2016; acute malnutrition remained unchanged; and overall

agricultural production in 2015/16 decreased only marginally (and remained higher than overall production levels two years earlier in 2013/14).^b The food security indicators in the Welfare Monitoring Survey tell a largely similar story: the share of the Ethiopian population who experienced a food shortage in the 12 months prior to the survey decreased from 22 percent in 2011 to 10 percent in 2016 (table B2.2.1). The food gap—the number of months a household experiences food shortage—remained the same but, given that the gap only refers to those households who actually experienced food shortages, it also decreased at the aggregate level. At the regional level, only Benishangul-Gumuz experienced a self-reported increase in food insecurity from a low base.

Table B2.2.1: Food Security Improved between 2011 and 2016

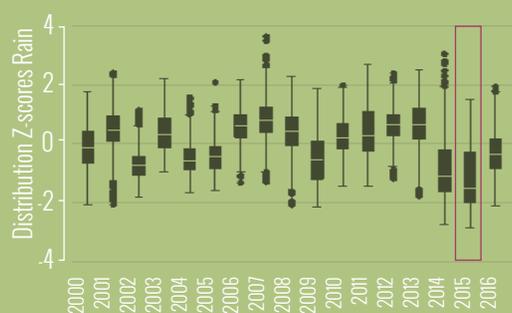
incidence of food shortages and average duration of food shortages—food gap)

Region	2011		2016	
	Food shortage (%)	Food gap (months)	Food shortage (%)	Food gap (months)
Tigray	13.2	3	11.9	2.5
Afar	7.7	5.2	9	3.8
Amhara	23.2	3.1	10.4	3
Oromia	16	3.1	10.5	3.6
Somali	30.3	4.4	6	3
Benishangul-Gumuz	5.6	2.1	8.5	2.8
SNNPR	35	3.4	12.6	3.2
Gambella	31.6	2.6	3.8	1.2
Harari	8	3.2	0	-
Addis Ababa	7.8	4	1.1	3.6
Dire Dawa	13.5	1.6	7.7	2
National	21.6	3.3	10.2	3.3

Sources Welfare Monitoring Surveys 2011, 2016; World Bank staff calculations.

Note The food gap is only calculated for those households who reported a food shortage. SNNPR = State of Southern Nations, Nationalities, and Peoples' Region.

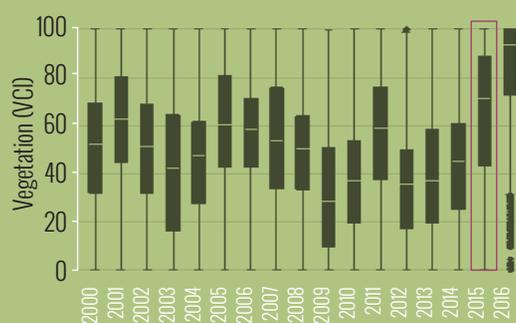
Figure B2.2.1 Bad Rains...
(rainfall deviations from long-term averages)



Sources Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Note SNNPR = State of Southern Nations, Nationalities, and Peoples' Region.

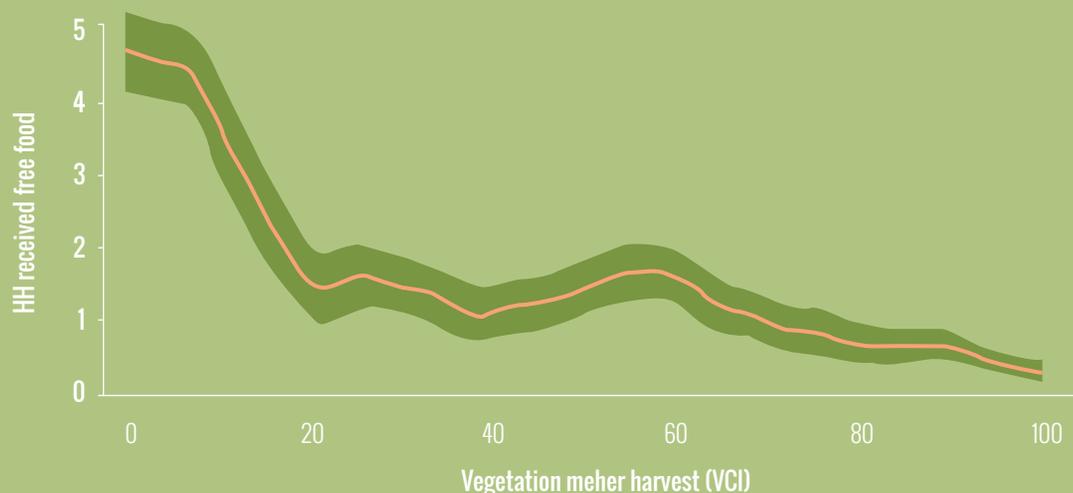
Figure B2.2.2 Good Vegetation...
(VCI)



Sources Sohnesen 2018, based on data from NASA's National Oceanic and Atmospheric Administration.

Note VCI measures the state of vegetation in a given year compared with similar periods in the previous years. VCI = Vegetation Condition Index.

Figure B2.2.3. Food Aid Targeted Locations with Unusually Poor Vegetation
(likelihood of receiving food aid as a function of the VCI)



Sources Sohnesen 2018.

Note Local polynomial smoothing between receiving food aid and the VCI. HH = households; VCI = Vegetation Condition Index.

a. Based on the 2016 Humanitarian Requirements Document.

b. Based on the Ethiopian Demographic and Health Surveys (2011 and 2016) and Agricultural Sample Surveys (2011–16).

c. When using a self-reported indicator of drought exposure, there is a large negative impact of (self-reported) drought exposure on consumption. This is likely due to endogeneity: people who have had a bad year are more likely to report having been exposed to shocks.

2.3 Patterns of Growth in Consumption Expenditure

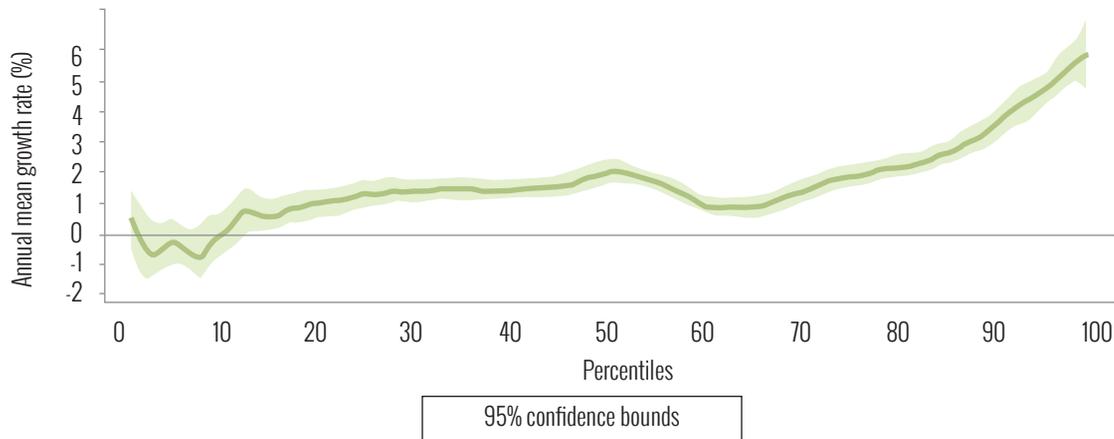
Consumption Growth Concentrated in the Upper Parts of the Distribution

The patterns of consumption growth between 2011 and 2016 were very different at the bottom and top of the distribution.

Figure 2.4 shows the average annual percentage change in consumption between 2011 and 2016

for each percentile of the distribution, ranging from the poorest 1 percent to the richest 1 percent. Growth for the bottom 20 percent was between 0 and 1 percent per year, in contrast to the top of the distribution where growth rates reached a maximum of just under 6 percent per year. The overall average increased by 2.4 percent per year, while the median (50th percentile) grew at 2 percent per year, on average.

Figure 2.4. Consumption Growth Was Zero for the Poorest and Strongly Positive for the Richest (average annual growth rate of consumption by percentile between 2011 and 2016)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Growth rates were strong and positive across the whole urban distribution.

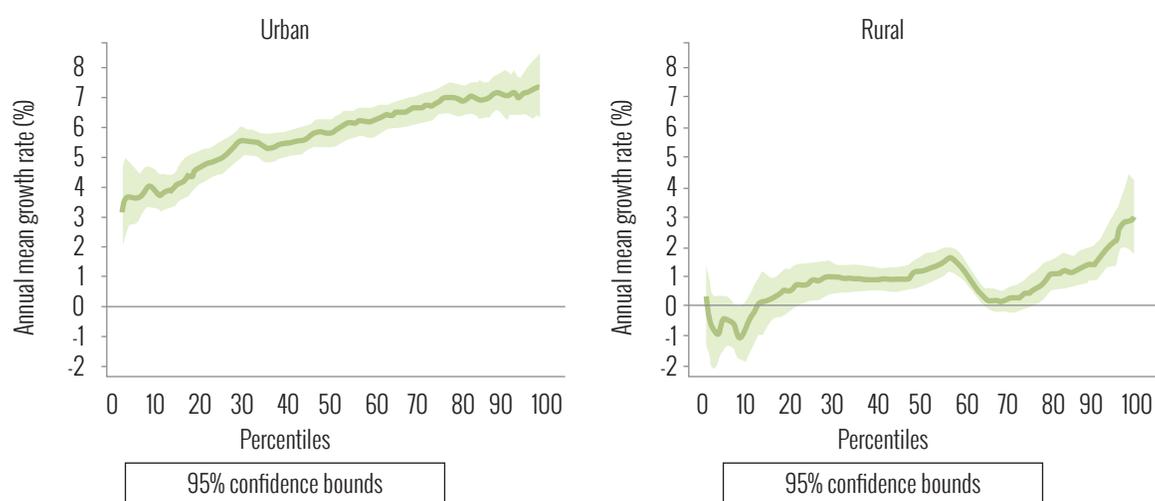
Annual growth across the urban consumption distribution was always above 3 percent and became increasingly strong toward the upper end (figure 2.5, panel a). The growth rate of the mean in urban areas was almost two-and-a-half times the national average, at 5.9 percent per year. There was a similar average growth rate for the urban median.

In contrast, rural consumption growth rates were generally quite low and more

variable. Figure 2.5, panel b, shows that growth was zero or negative for the poorest households in rural areas. The growth rate picked up to around 1 percent at the median, but then dropped back to just above zero until around the 80th percentile. As was the case for urban areas, the highest growth rates were experienced at the top of the rural distribution, although they were relatively lower at around 3 percent per year. The rural average grew at 1 percent per year, a rate that was almost six times lower than in urban areas. Rural growth was statistically different from zero only in Tigray, Gambella, and Harari.



Figure 2.5. Growth Was Strong and Positive in Urban Areas but Lower and Variable in Rural Areas
(average annual growth rate of consumption by percentile between 2011 and 2016)

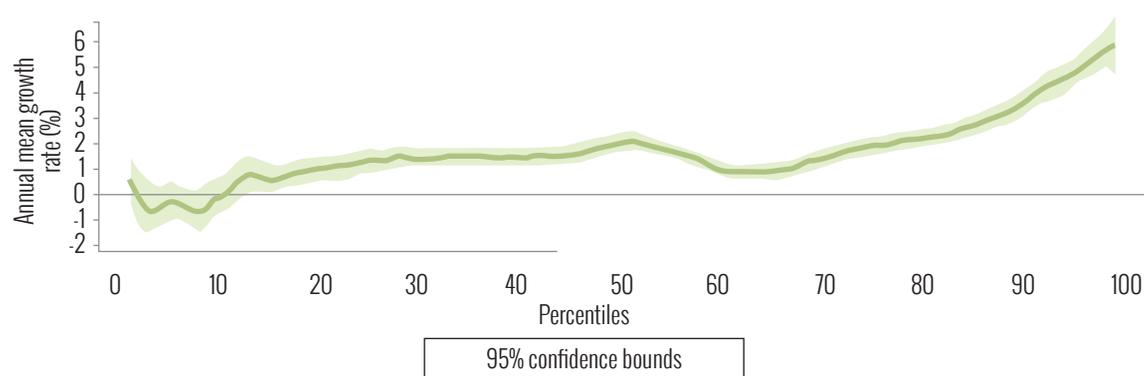


Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

The pattern of growth in rural areas is a continuation of the pattern observed between 2005 and 2011. Consumption of the bottom 15 percent in rural areas contracted between 2005 and 2011 (figure 2.6) (World Bank 2015), much the same as it did between 2011 and 2016 (figure 2.5, panel b). Given the cross-sectional nature of the HCES data, this does not necessarily imply that households who were poor to begin with (in 2005) have increasingly

become more impoverished. However, it does mean that whoever was in the bottom 15 percent of rural welfare in 2016 had lower monetary living standards than whoever was in the bottom 15 percent in 2005. The indicators of poverty severity that will be presented later are consistent with this pattern. These numbers suggest the existence of a segment of the rural population that has not benefited from Ethiopia's economic growth (box 2.3).

Figure 2.6. Growth Was Negative for the Bottom 15 Percent in Rural Areas between 2005 and 2011
(average annual growth rates of rural consumption by percentile, 2005–11)



Source Household Consumption Expenditure Surveys 2005, 2011; World Bank staff calculations.

Box 2.3

Chronic and Transitory Poverty in Ethiopia: Evidence from the Ethiopia Socioeconomic Survey

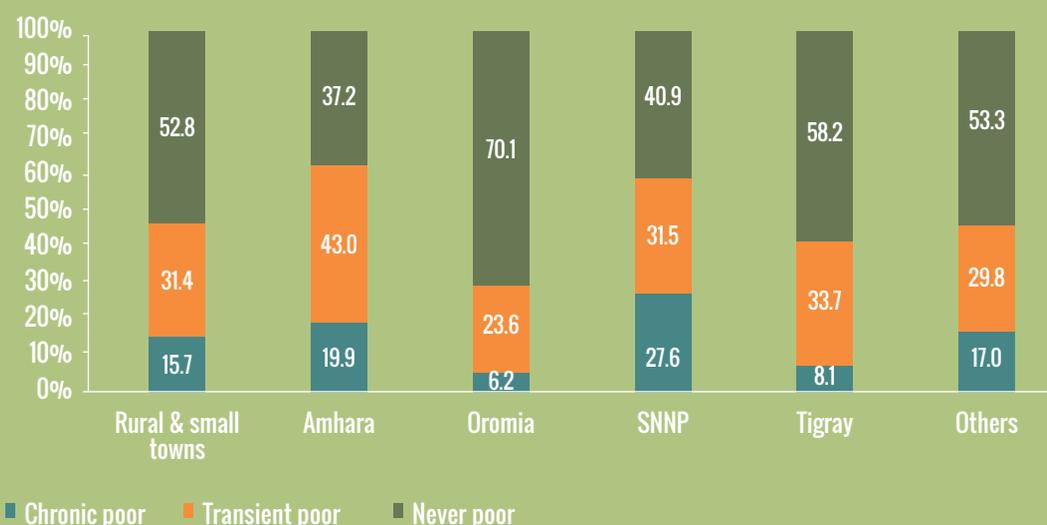
The Household Consumption Expenditure Surveys interview a different sample of households in different years. Although this allows the surveys to get information on the change in poverty over time, it does not allow studying the fate of individual households over time. The Ethiopia Socioeconomic Survey (ESS), implemented in 2012, 2014, and 2016, follows the same sample of households in three successive survey rounds. The longitudinal nature of the ESS means that households can be separated into those that are chronically poor and those that experienced transitory poverty. The importance of this for policy purposes is highlighted by the fact that an appropriate policy response to chronic poverty would focus on increasing the attainment of and returns to the assets (human and physical) of the poor. Transient poverty would be better tackled through initiatives that focus on insurance and income stabilization. Accordingly, conclusions about longer-run welfare depend on how much mobility is present over time in society (Lipton and Ravallion 1995).

Chronic poverty status is assigned to households who are always poor or usually poor over the three rounds of the ESS (2012, 2014, and 2016). A household

that is always poor is one that is observed to be below the poverty line in all three rounds of the ESS.^a A household that is usually poor is one in which the average of consumption expenditure over the three rounds of the ESS is below the poverty line, although the household is not poor in all three rounds. Transitory poverty is associated with those households that are occasionally poor—average consumption expenditure over the three rounds of the ESS is above the poverty line, but the household is poor in at least one round.

Overall, 16 percent of the population in rural areas and small towns in Ethiopia was chronically poor, according to the definition outlined above. This was significantly lower than the 31 percent of households that experienced transitory poverty over the period. Economic mobility (moving above and below the poverty line over time) was very high over the period and goes some way to explaining why the transitory component is so high for these households. Overall, taking account of chronic and transitory poverty, about half the population in rural areas and small towns experienced at least one spell of poverty between 2012 and 2014.

Figure B2.3.1. Chronic and Transitory Poverty over ESS 2012 to ESS 2016: Households in Rural Areas and Small Towns



Sources Staff calculations from ESS 2012, 2014, and 2016.

Note ESS = Ethiopia Socioeconomic Survey; SNNPR = State of Southern Nations, Nationalities, and Peoples' Region.

There were large regional differences in the extent of chronic poverty.^b Chronic poverty rates were highest in the State of Southern Nations, Nationalities, and Peoples' Region (SNNPR) and Amhara, at 28 and 20 percent of the rural and small-town population, respectively. Six percent of this population in Oromia was in chronic poverty between 2012 and 2016, while the share in Tigray was 8 percent. Rates of transitory poverty were a bit more evenly spread throughout the regions, ranging from 24 percent in Oromia to 43 percent in Amhara. A little over half of all households were never poor between 2012 and 2016 (shown by the grey bars in figure B2.3.1). This aggregate number hides some large regional differences. Only 37 percent of households in Amhara were not poor in any one of the three rounds of the ESS, compared with 58 percent in Tigray and 70 percent in Oromia. Shifting the focus to the five agro-ecological zones of Ethiopia shows that households

located in moisture-reliable highlands were disproportionately more likely to have been in chronic poverty between 2012 and 2016.

Apart from being more likely to be located in SNNPR and Amhara, chronically poor households in Ethiopia differ from transitory poor or never poor households in several characteristics (table B2.3.1). Chronically poor households are larger, contain more young children, and have higher dependency ratios than transitory poor households and those that were never poor.^c They have less arable land, fewer assets (as measured by their score on a composite asset index), and are more likely to be headed by a male with little to no education.^d They are more likely to have experienced food shortages, and their children are less likely to go to school. Surprisingly, chronically poor households are not significantly more remote than those households that did not experience

poverty between 2012 and 2016. The average chronically poor household was located about 14 kilometers from the nearest road, while the corresponding distances for the transitory poor

and never poor were 16 and 14 kilometers, respectively. Proximity to the nearest population center of 20,000 people or more also did not vary much between the groups.

Table B2.3.1: Profiles by Poverty Status, Nonurban Households, 2012 to 2016

Characteristic	(1) Chronic poor	(2) Transitory poor	(3) Never poor	Diff. (1) versus (2)	Diff. (1) versus (3)
Household					
Household size	59	5.3	4.9	***	***
Dependency ratio (%)	101	89	74	*	***
Land per adult (hectares)	0.32	0.43	0.57	***	***
Asset index	-0.4	-0.2	0.2	**	***
Distance to nearest road (kilometers)	13.7	16.7	14.0	***	
HH ever in PSNP (W1 to W3) (%)	25.2	20.8	19.0		*
Not enough food last 12 months (%)	47.4	35.6	27.8	***	***
Children ages 7-12 enrolled (%)	63.4	69.2	74.6	**	***
Household head					
Age (years)	43.8	46.0	44.4	**	**
Female (%)	17.5	18.2	22.0	**	***
No education (%)	70.3	71.5	57.3	**	***
Primary (%)	29.2	25.7	35.2	*	*
Secondary (%)	0.4	2.4	4.2	***	***
Post-secondary (%)	0.0	0.5	2.9	**	***

Sources Staff calculations from ESS 2012, 2014, and 2016.

Note ESS = Ethiopia Socioeconomic Survey; HH = household; PSNP = Productive Safety Net Programme; W = Wave. *** significant difference at 1% level, ** 5% level, * 1% level.

a. The poverty line in this analysis is set at the 25th percentile of the 2016 ESS distribution of consumption expenditure, which roughly corresponds to the official 2016 poverty rate.

b. In this context, the region in which a household is located is the region that was recorded in 2012.

c. The definition of the dependency ratio comes from the Central Statistical Agency of Ethiopia (2017) and is "...the population that is not of working age (<15 and >64) divided by total number of working age persons (15-64 years). The value is then multiplied to express it in percent. Households with no working persons were excluded in the dependency ratio computation."

d. The conventional wisdom is that female-headed households are more likely to be poor. This is mistaken.

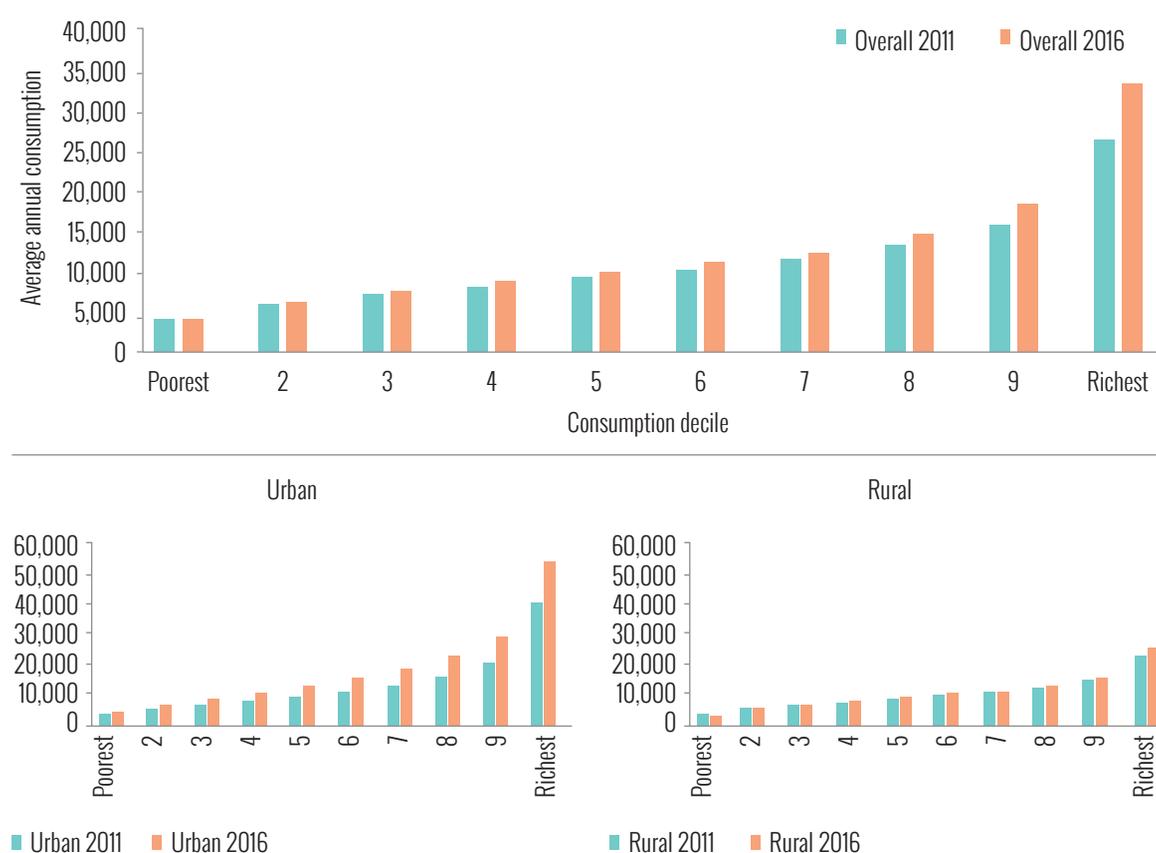
Although growth was higher in the upper half of the distribution, most of the population experienced an increase in consumption between 2011 and 2016.

Only in the first decile (the poorest 10 percent of the population) was there no growth in real consumption levels: consumption expenditure in the poorest decile was constant at around Br 3,800 per adult equivalent per year (in December 2015 prices). Small increases took place for deciles 2 to 8, while average consumption in decile 9 jumped from Br 15,700 to Br 18,000. The biggest real gains took place for the richest 10 percent, whose average real consumption expenditure increased

from Br 26,000 to Br 33,000 (per adult equivalent per year).

In urban areas, there was consumption growth across the distribution. Consumption expenditure grew by Br 800 for the poorest 10 percent, and by almost Br 14,000 for the richest 10 percent of urban households.¹⁵ Figure 2.8, panel b confirms that although every urban decile experienced a real increase in consumption expenditure, growth was strongest at the top. Growth in rural households was a lot flatter—the top 10 percent of rural households saw an increase of Br 2,400 on average between 2011 and 2016.

Figure 2.7. Real Consumption Increased Everywhere Except the First Decile
(real annual consumption expenditure, by decile, between 2011 and 2016, December 2015 birr)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

¹⁵ This is in contrast to 2005–11, during which the bottom 10 percent of the urban population contracted in consumption expenditures (World Bank 2015).

Given that consumption growth between 2011 and 2016 was higher in the upper half of the distribution, inequality increased somewhat.

The Gini coefficient of inequality increased from 0.29 in 2011 to 0.33 in 2016 (FDRE 2017). This inequality level is still low and lower than the average for Sub-Saharan African countries. An urban-rural decomposition shows that there was a substantial increase in the contribution of inequality between urban and rural areas to overall inequality; the contribution of inequality within urban and rural areas decreased. In other words, inequality increased because urban households, who were already better-off to begin

with, experienced faster consumption growth between 2011 and 2016.

The slight increase in inequality should not be a cause for concern, at least for now.

This pattern is a familiar one in fast-growing and urbanizing countries and can be expected to continue until rural and urban welfare levels start to converge through increased migration to urban areas. It would only be a cause for concern in a scenario of restricted labor mobility, where workers from rural areas cannot move freely to more economically dynamic urban areas. In that case, urban-rural income gaps could be expected to increase further, pushing up spatial inequality.

2.4 Brief Snapshot of Current Monetary Living Standards

Despite strong poverty reduction over the past 20 years, standards of living in Ethiopia remain low.

In the 2015/16 survey, median household consumption per capita amounted to Br 704 per month.¹⁶ Converting this amount to U.S. dollars and accounting for the differences in purchasing power, this means that half the population in Ethiopia lives on consumption expenditure of purchasing power parity (PPP) US\$86 per month or less.¹⁷ For rural areas, this amounts to US\$82 (PPP adjusted). Overall, monetary living

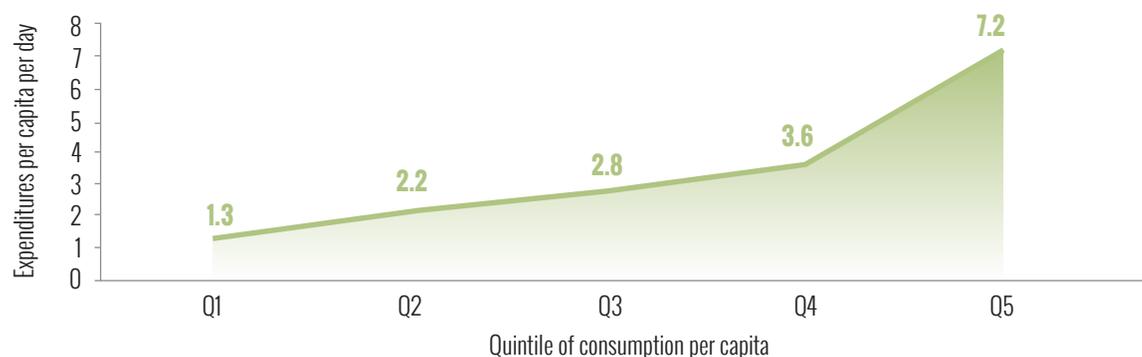
standards are low for the bottom 80 percent of the population but sharply increase in the fifth quintile (figure 2.9). The fifth quintile is structurally different from the other quintiles, in the sense that it is predominantly urban, better educated, and much more likely to be wage-employed in the public sector or self-employed in the formal private sector. In comparative perspective, poverty in Ethiopia is low relative to the country's income level, but the extent to which growth has translated into poverty reduction has also been low.



¹⁶ This figure is expressed on a per capita basis. As a result, it is different from the figure presented in section 2.2, which uses a per adult equivalent basis.

¹⁷ The PPP conversion factor for private consumption was Br 8.189 for US\$1 in 2015 (World Bank 2018).

Figure 2.8. Monetary Living Standards Remain Low for the Majority of the Population
(daily expenditures per capita, US\$ PPP)



Sources Household Consumption Expenditure Survey 2016; World Bank staff calculations.

Note PPP = purchasing power parity.

Although Ethiopia has managed to continue its progress on poverty reduction in adverse circumstances (the El Niño drought), the severity of poverty has remained stubbornly sticky. Poverty severity is an indicator of the distance that separates the poor from the poverty line, and it gives more weight to the very poor (those households with the lowest consumption expenditures). According to the official poverty

report, poverty severity in rural areas did not change between 2011 (poverty severity of 3.2) and 2016 (poverty severity of 3.1) and remains higher than in 2005 (2.7) (FDRE 2017).¹⁸ There is also significant regional variation. Poverty severity increased in the rural areas of Oromia, Harari, and Dire Dawa.¹⁹ It decreased in Afar, Somali, Benishangul-Gumuz, SNNP and Gambella while it remained the same in Tigray and Amhara (figure 2.10).

Figure 2.9. Rural Poverty Severity increased in Oromia, Harari and Dire Dawa
(Rural poverty severity across regions: 2011 and 2016)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations

¹⁸ FDRE, 2017.

¹⁹ The increase in poverty severity does not mean that poverty increased (poverty decreased). Rather, it means that the (fewer) people who were poor in 2016 were on average poorer than the people who were poor in 2011.

2.5 Perspectives on Poverty Reduction Going Forward

The analysis presented in this Economic Update is largely descriptive and, as such, cannot make too strong a statement on the way forward for poverty reduction in Ethiopia. The upcoming Poverty Assessment will provide a deep analysis of poverty trends and make more links to public action. There are nevertheless some important questions to extract from the recent Welfare Monitoring Survey and HCES data and existing academic and policy research. These questions relate to the role of agricultural development in reaching the poorest of the poor, the state of education in rural Ethiopia, and population dynamics and job creation.

Although improvements in agriculture have driven poverty reduction over the past 15 years (World Bank 2015), it begs the question as to what extent the smallholder-focused poverty reduction strategy has been able to reach the poorest of the poor in rural areas.

Successive HCES surveys show that the bottom 10-15 percent in rural areas experienced no growth in consumption between 2005 and 2015, resulting in rural poverty severity that was higher in 2015 than in 2005. The chronic poor in rural Ethiopia have less land and bigger families, meaning that the little land they have will become even more subdivided in the future generation. All in all, this suggests that there will not be an agriculture-based pathway out of poverty for Ethiopia's chronic poor.²⁰ Although social programs like the Productive Safety Net Programme provide much-needed relief to extremely poor rural families, the question remains whether this is, on its own, sufficient to lift ultra-poor households to a sustainably better standard of living while allowing them to invest in the human capital of their children.

In an ideal scenario, the children of extremely poor households would accumulate more education and be able to move out and diversify into more productive activities, breaking the intergenerational transmission of poverty. Better-educated young people from rural areas tend to move to urban areas and substantially improve their material conditions. Despite the improvements in access to education, few youths in rural areas in Ethiopia complete primary school. According to the 2015 Welfare Monitoring Survey, 22 percent of youth ages 15-24 years in rural Ethiopia had completed primary school, dropping to 14 percent in the bottom quintile (the poorest in rural areas). Overall, the median years of education obtained by rural youth (ages 15-24) in Ethiopia amounts to five (lower for those in poor households). With these education statistics, it is difficult to imagine that the living standards of today's poor children or youth will improve much as they enter adulthood and start their own families. Devising policies or interventions to keep children from poor rural families in school longer will be crucial in any attempt to share the benefits of growth more widely.

In a context of increasing land scarcity, the labor market will become increasingly important as a transmission mechanism between aggregate growth and poverty reduction. The Government of Ethiopia acknowledges this and expanding employment opportunities is a priority area in the second Growth and Transformation Plan. The challenge is daunting: over the next 10 years, the working-age population in Ethiopia will grow at two million per year, dramatically increasing the population's demand for jobs. Even if Ethiopia's manufacturing

²⁰ At least not in own-account agriculture on small and degraded fields. Agricultural wage labor on other farms or commercial farms could potentially be a pathway.

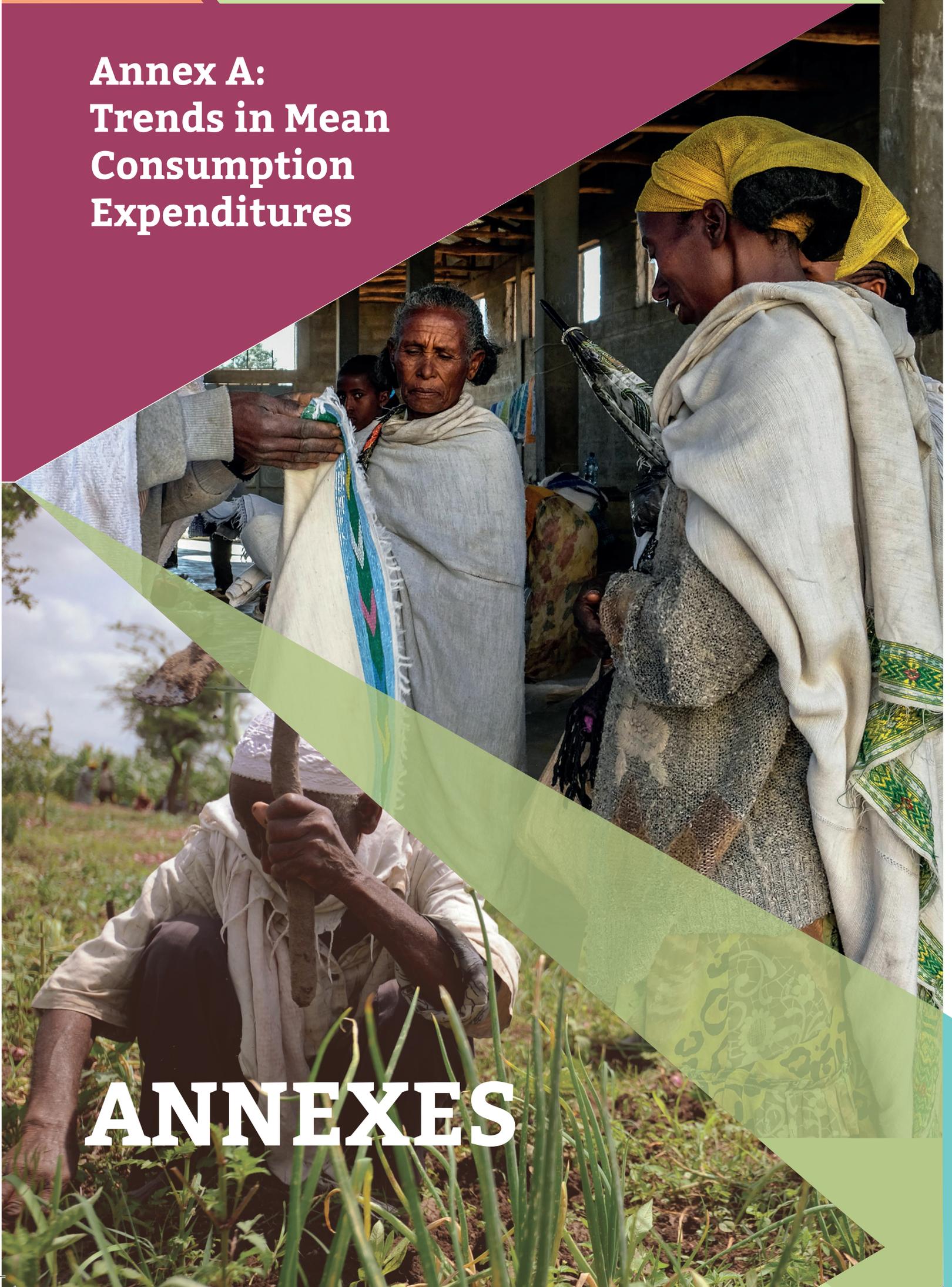
drive turns out to be highly successful, the number of jobs created will not come close to the number required. Successfully addressing the employment challenge will require interventions, improvements, and innovations in many different sectors and dimensions and a critical review of existing employment policies and strategies.

A final reflection, linked to the employment challenge, relates to issues of fertility and family planning. Progress on poverty reduction, job creation, and schooling is complicated by persistently high fertility rates. Although the total fertility rate in Ethiopia declined from 5.5 in 2000 to 4.6 in 2016, rural fertility remains high, at 5.2 children

per woman (in 2016) (Ethiopia Demographic and Health Surveys 2000, 2011, and 2016). In addition, the fertility decline has stalled in recent years: the total fertility rate was largely similar in 2016 (4.6) to what it was in 2011 (4.8). The persistently high fertility rate means that future youth cohorts will become larger and the challenges for education and job creation will become bigger. To illustrate, there are currently 21 million youths (ages 15-24) in Ethiopia. By 2030, there will be close to 28 million (UN DESA 2015). Achieving faster declines in fertility through improved access to family planning, girls' education, and better female labor force participation will be required to manage the twin challenges of education and employment in the decades to come.

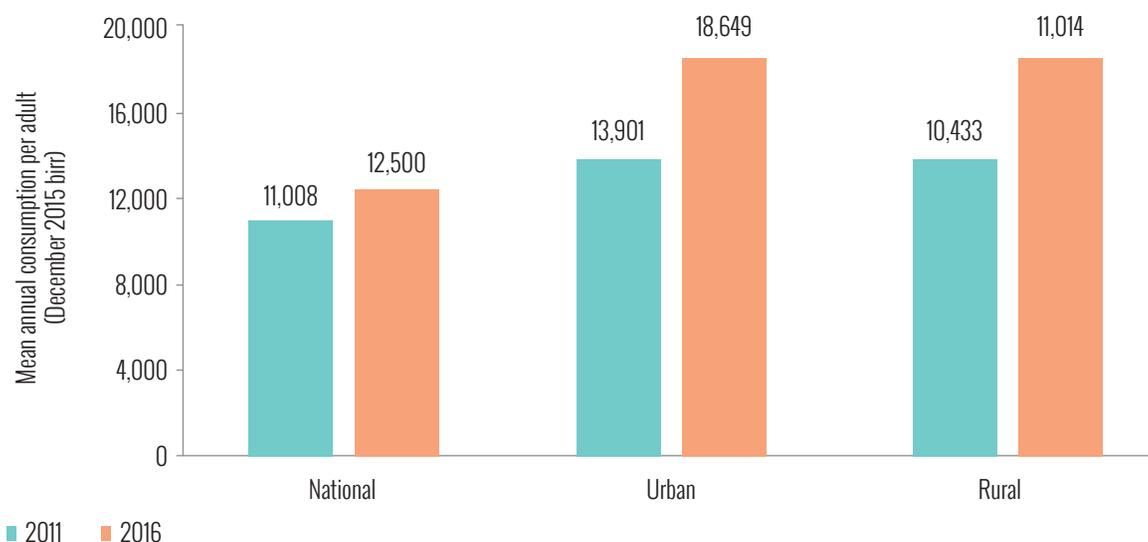


Annex A: Trends in Mean Consumption Expenditures



ANNEXES

Figure A.1. Mean Annual Consumption per Adult, 2011 and 2016
(December 2015 birr)



Source Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

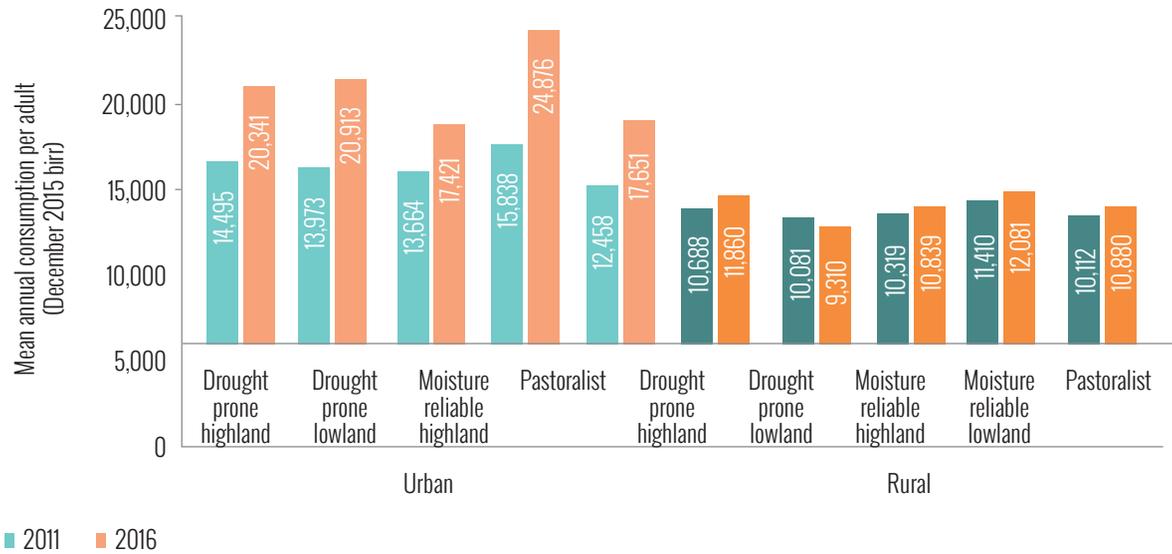
Table A.1: Regional Mean Annual Consumption per Adult, 2011 and 2016
(December 2015 birr)

Region	Total			Urban			Rural		
	2011	2016	% change	2011	2016	% change	2011	2016	% change
Tigray	11,630	14,108	21.3	17,691	20,536	16.1	10,074	12,038	19.5
Afar	10,641	12,902	21.2	13,945	18,645	33.7	9,298	10,463	12.5
Amhara	10,944	12,340	12.8	14,325	21,879	52.7	10,464	10,557	0.9
Oromia	10,947	12,022	9.8	13,891	18,080	30.2	10,504	11,022	4.9
Somali	10,565	11,714	10.9	12,942	14,470	11.8	10,004	11,063	10.6
Benishangul-Gumuz	11,435	13,373	17.0	15,124	18,524	22.5	10,832	12,112	11.8
SNNPR	10,725	12,204	13.8	13,391	18,049	34.8	10,414	11,157	7.1
Gambella	10,334	13,855	34.1	12,477	17,945	43.8	9,325	11,745	26.0
Harari	13,264	21,059	58.8	15,344	24,028	56.6	11,397	17,479	53.4
Addis Ababa	12,831	16,237	26.5	12,831	16,237	26.5	-	-	-
Dire Dawa	11,268	17,428	54.7	11,617	20,718	78.3	10,532	11,393	8.2

Sources Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Note The increase in mean consumption is statistically significant in all regions except Somali. For rural areas, the increase in mean consumption is statistically different from zero only in Tigray, Gambella, and Harari. SNNPR = State of Southern Nations, Nationalities, and Peoples' Region.

Figure A.2. Mean Annual Consumption per Adult in the Five Agro-Ecological Zones, Urban and Rural (December 2015 birr)

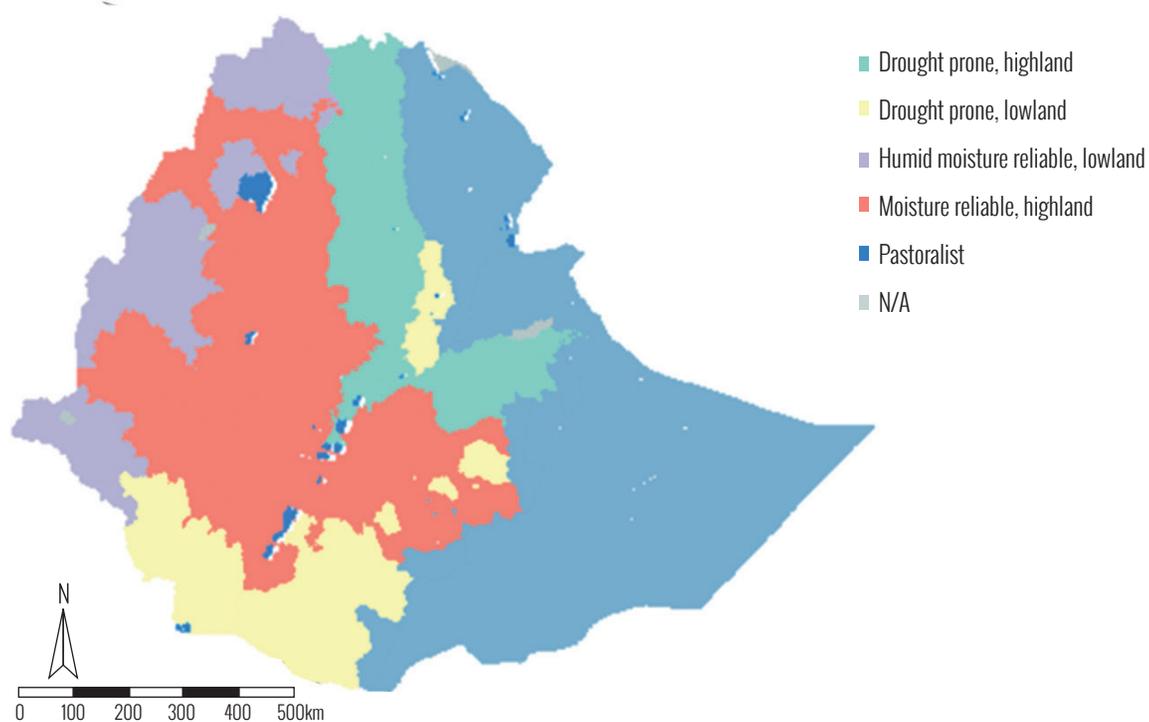


Sources Household Consumption Expenditure Surveys 2011, 2016; World Bank staff calculations.

Note The increase in mean consumption is statistically significant in all agro-ecological zones. For rural areas, the increase in mean consumption is statistically different from zero only in the highlands (drought-prone and moisture-reliable).

Annex B: The "Five Ethiopias"

Map B.1. Agro-Ecological Zones of Ethiopia



Sources :<please provide>

Note The moisture-reliable highlands-cereal and moisture-reliable highlands-enset are lumped into one group for the analysis. The nonclassified parts of Somali and Afar are considered pastoral.

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