Governor's Note

I am pleased to present, dear readers, the 2006/07 Annual Report of the National Bank of Ethiopia which reviews the latest developments witnessed in the Ethiopian economy in the context of the world economy.

The Ethiopian economy continued to grow in 2006/07, putting Ethiopia among the top performing economies in Sub-Saharan Africa (SSA). The economy grew by 11.4 percent compared with 11.6 percent in 2005/06. With its 45.9 percent share in GDP, agriculture remains the major contributor to the overall economic performance, growing by 9.4 percent due to increased productivity, expansion of land under cultivation and favorable weather conditions. The crop sub-sector is the main driving force for the sector's growth.

The contribution of non-agricultural sectors to the overall growth was also significant indicating that growth is becoming more broad-based. The industrial sector, with a share in total GDP of 13.3 percent, grew by 11 percent. The growth in industry was due to expanded investments in hydroelectric power generating stations and the water sub-sector. The contributions of the manufacturing, mining and quarrying, and construction sub-sectors were also encouraging. Similarly, the steady increase in the share of the service sector in overall real GDP over the last three years has been reinforced by the 13.5 percent growth to reach 40.8 percent by the end of 2006/07. Financial intermediation has also seen improvements during the last four years.

With regard to energy generation and distribution, significant progress has been made in a bid to attain the target set for the year 2010 to increase power generation capacity and the number of electrified cities and towns. However, further efforts need to be made to harness the vast potential that the country has in this sector.

With the improved investment climate, Ethiopia has continued to attract and expand both domestic and foreign investment as evidenced by the increasing number of approved projects, the growing number of projects that go operational and the magnitude of employment opportunities they create. In 2006/07 alone, a total of 6,472 projects with a capital of Birr 93.6 billion were approved, the highest since 1992/93. When implemented, these projects are expected to create job opportunities for over 300,000 workers.

With regard to price developments, the inflationary pressure has remained the most serious concern of the government. Rapid economic transformation and accompanied structural changes as well as rising world commodity prices have contributed to higher domestic prices. Accordingly, taking December 2000 as the base year, headline inflation, led mainly by food inflation, reached 17.0 percent at the end of 2006/07, 4.7 percent higher than that of the preceding year. The 18.1 percent food price inflation recorded in the year was ascribed to a rise in the prices of cereals, pulses, oil and fats, and vegetables and fruits. The 14.8 percent core (non-food) inflation compared with 7.9 percent a year earlier was also high in the Ethiopian context. The increase in underlying inflation was largely attributable to the increase in the prices of house rent, construction materials, water, fuel and power, clothing and footwear. In order to address the inflationary pressure and give signals to economic agents, the National Bank of Ethiopia (NBE) raised the reserve requirement from 5 to 10 percent and the minimum interest rate on savings and time deposits from 3 to 4 percent in July 2007. Other concerted policy measures were also taken to mitigate the adverse effects of inflation on the economy in general and the urban poor in particular.

Government fiscal operations were also supportive of economic growth. Revenue and grants increased by 27.3 percent over the last year and revenue to GDP ratio was 12.8 percent. Tax revenue rose by 22 percent and continued to account for the lion's share (79.6 percent) of total revenue due to improved tax collection and administration. At the same time, government expenditures were 21.1 percent higher than that of last year as poverty-reducing expenditures continued to increase over the last fiscal years. As a result, the fiscal deficit of the general government (including grants) stood at 3.1 percent of GDP, lower than 3.9 percent in 2005/06.

During the year under review, broad money supply grew by 22.2 percent, less than the 29.8 percent growth in nominal GDP. This prudent monetary policy was consistent with the NBE's primary objective of maintaining price stability with growth. As monetary indicators show, growth in broad money supply was due to the increase in both domestic credit and net foreign assets. The expansion in private sector domestic credit was associated with the boom in private sector businesses coupled with favorable interest rates. Savings and time deposits also continued to grow despite negative real rates of interest. Financial deepening tended to decline to 33 percent against the previous year, reflecting the tight monetary policy pursued during the review fiscal year. Excess reserves of commercial banks remained high due to higher resource mobilization by banks vis-à-vis their lending. Cognizant of this fact, concerted efforts are being made to reduce excess liquidity of the banking system using various methods, including sale of Treasury Bills.

Encouraging results have also been observed in the financial sector. With new banks coming into the sector, the number of commercial banks operating in the country reached 11 with the total number of branches increasing to 487 from 421 last year. However, the high people to bank branch ratio indicated that Ethiopia still remains as one of the under-banked economies even by SSA standards. Ethiopian banks have continued to show significant profits, widening capital base, higher resource mobilization and loan disbursement as well as falling of nonperforming loans. Other soundness indicators also show the healthy pace of the industry. The total deposits and loans of these financial institutions rose by 45.3 and 39.5 percent, respectively. The banks also disbursed fresh loans to the tune of birr 15.6 billion in 2006/07, about 26 percent higher than last year of which over 59 percent was disbursed by private banks and 74 percent of the fresh loans went to the private sector.

At the same time, although the number of insurance companies remained at 9, their total capital grew by 3.5 percent over that of the previous year and all of them showed profit from their operations. With regard to the microfinance sector, the number of institutions rose to 28. Their total capital and assets increased by 23.2 and 34.6 percent, respectively. These microfinance institutions have mobilized Birr 1 billion in deposits and disbursed loans amounting to Birr 2.7 billion by the end of 2006/07. In this case, microfinance institutions are playing a positive role in alleviating poverty in the country.

As for external sector development, Ethiopia's exports increased by 18.5 percent to USD 1,185 million in 2006/07 due to increases in the volume and price of all export items except oil seeds and meat. The latter two export items showed a decline in volume despite higher prices during the review period. Further diversification of Ethiopia's exports has shown an encouraging trend. At the same time, imports went up by 11.6 percent to USD 5.13 billion as all types of imports except semi-finished goods, tended to rise, reflecting growing demand of the economy despite increasing import prices in the international market. Hence, the merchandise trade deficit continued to widen although the current account deficit as a whole (including official transfers) narrowed to 5.7 percent of GDP due to surpluses in services and unrequited transfers accounts. Net private transfers reached USD 1.69 billion of which USD 1.17 billion was contributed by private individuals. There was also a surplus in the capital account mainly due to the rise in net official long-term capital and net foreign direct investment. As a result, the balance of payments recorded a surplus of USD 85 million compared with a deficit of USD 207.5 million a year earlier. Accordingly, the country's gross reserves coverage reached 2.2 months of imports in 2006/07.

With regard to developments in the foreign exchange market, the weighted average exchange rate of the Birr in the official market showed a depreciation of 1.3 percent against USD compared to the preceding fiscal year, while that of the parallel market appreciated by 0.8 percent resulting in a 1.9 percent premium. In the official market, the Birr depreciated against all currencies of Ethiopia's major trading partners except the Yen. Meanwhile, the real effective exchange rate tended to appreciate despite a depreciation of 4.0 percent in the nominal effective exchange rate due to higher domestic inflation compared to Ethiopia's major trade partners. Accordingly, efforts are underway to mitigate the effect of the appreciation of real effective exchange rate and the consequent loss of competitiveness of Ethiopia's exports.

Looking ahead, the Ethiopian economy is expected to grow by over 10 percent in 2007/08 due to the continued favorable macroeconomic environment. Monetary policy will remain geared towards maintaining price and exchange rate stability, ensuring soundness of the financial sector and creating a conducive environment for economic growth. Special attention will be given to mitigate the inflationary pressure by consolidating the existing measures and introducing new ones as necessary. Efforts will be made to ensure that the international reserves are adequate. Close coordination between monetary and fiscal policies will be pursued and the Bank will continue to support diversification of exports and enhance transfers and inward remittances to improve the external position of the country.

Finally, I would like to thank all those who worked hard and contributed to the positive achievements made in 2006/07 and urge them to continue to do so to enhance economic growth and development and to reduce poverty by half by the year 2015.