

The African Development Bank Group Chief Economist Complex



Economic Brief

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Ethiopia's Economic growth Performance: Current Situation and Challenges

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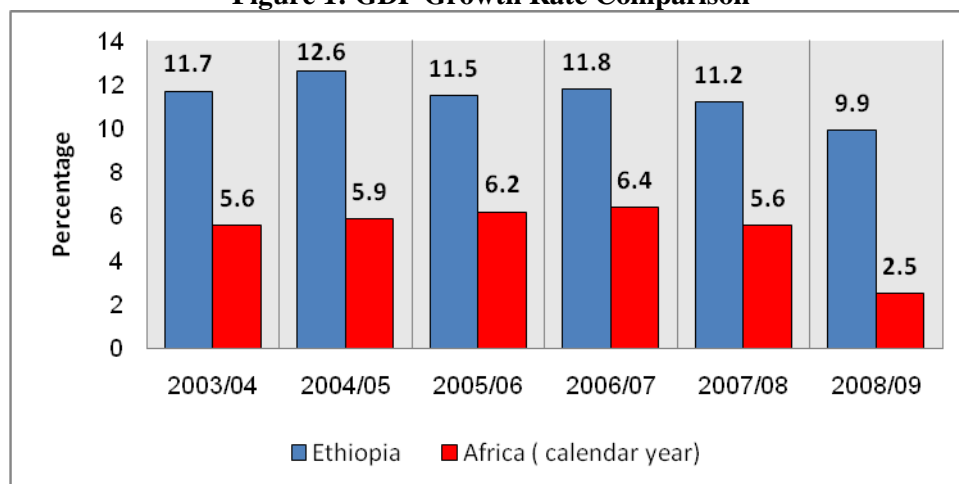
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1. Introduction

Ethiopia has experienced strong economic growth in recent years. With real GDP growth at or near double digit levels since 2003/04, the country has consistently outperformed

most other countries in Africa and expanded much faster than the continent-wide average (Figure 1). At the same time, the country still faces some structural weaknesses that present significant challenges in the medium term.

Figure 1: GDP Growth Rate Comparison



2. Recent Trend in Real GDP Growth

2.1. Real GDP growth averaged 11.2% per annum during the 2003/04 and 2008/09 period, placing Ethiopia among the top performing economies in Sub-Saharan Africa. This growth performance is well in excess of the population growth rate and the 7 percent rate required for attaining the MDG goal of halving poverty by 2015. Yet, a number of issues warrant the attention of policy makers.

2.2. Ethiopia's economy is highly vulnerable to exogenous shocks by virtue of its dependence on primary commodities and rain fed agriculture.

Ethiopia has experienced major exogenous shocks during the past five to seven years. These are notably droughts and adverse terms of trade (e.g., prices of coffee and fuel). There is a strong correlation between weather conditions and Ethiopia's growth performance.

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A change of 1 percent in average annual rainfall is associated with a change of 0.3 percent in real GDP in the following year. The last major shock to growth was in 2002/03 when the economy suffered a major decline in real GDP growth on account of severe drought. Since then real GDP growth has consistently been above or near two-digit levels.

2.3. Ethiopia's recent growth has been accompanied by mounting macroeconomic pressures (which are now easing). The country has had to grapple with the twin macroeconomic challenges of high inflation and low international reserves. Pressures on prices and the balance of payment heightened from FY 2007/2008 as a result of the global food and economic crisis. The difficult macroeconomic situation Ethiopia faced during the period FY 2007/08 to 2008/09 is also attributable to the structural weaknesses in the economy, including supply-side rigidities. The growing domestic supply-demand gap, in the context of the surge in growth, contributed to a rise of inflation and the depletion of foreign exchange between 2007/08 and 2008/09.

3. Sectoral Sources of Growth and Structural Shift

3.1. Although initially led by agriculture, the growth base is

broadening, with increasing contributions to GDP from services and industry.

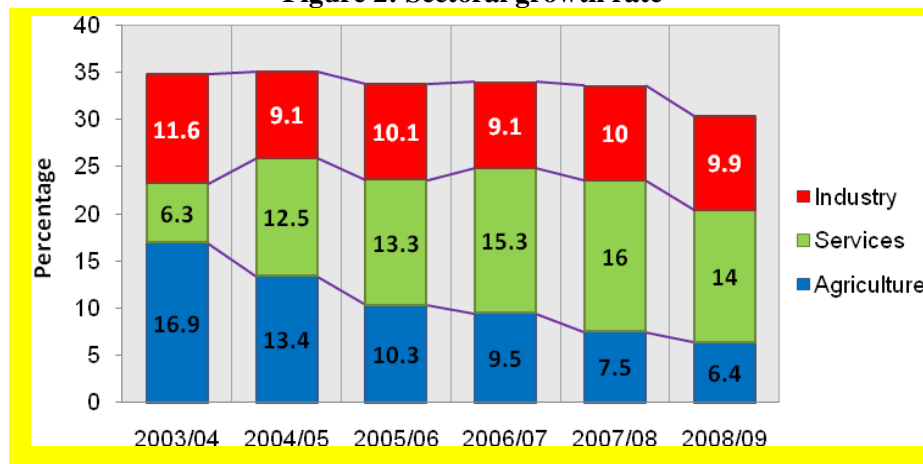
As illustrated in Figure 2, the pace of agriculture sector growth during the 2003/04-2008/09 period declined, while the industrial and services sectors grew more rapidly.

Until recently, agriculture (particularly small holder crop production) was by far the most dominant sector. In 2003/04 the crop production alone accounted for 60 percent of overall GDP growth.

Though agriculture production has increased considerably, due to favorable weather conditions and enhanced support by Government (e.g., improved supply of fertilizer) agricultural productivity remains low. The expansion in agriculture production has been driven by increases in the area of land cultivated, rather than major improvements in productivity. Given current technological conditions and the structure of production, pushing the production frontier further is difficult due to the already existing pressures on the land.

“Though agriculture production has increased considerably, due to favorable weather conditions and enhanced support by Government (e.g., improved supply of fertilizer) agricultural productivity remains low.”

Figure 2: Sectoral growth rate

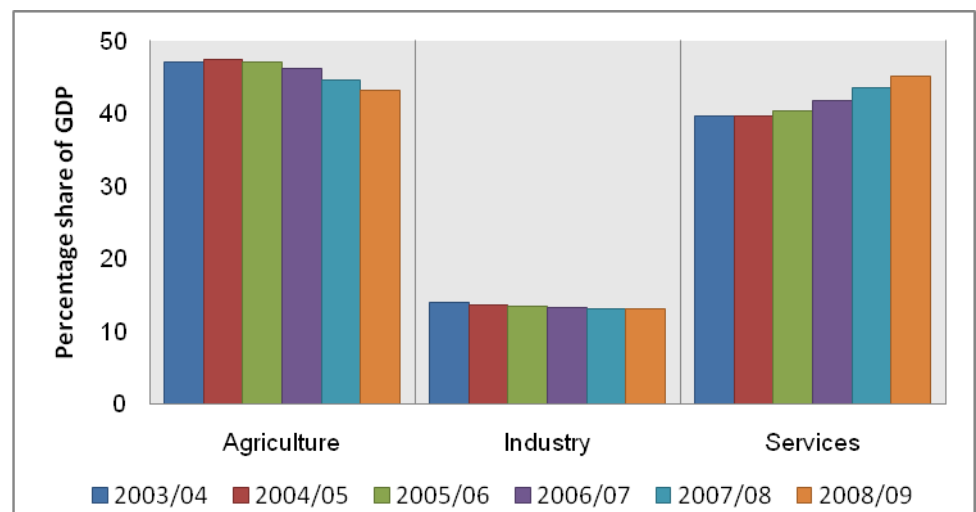


“The agriculture sector’s share of GDP declined by three percentage points between 2003/04 and 2008/09 and has now been surpassed by services.”

3.2. The share of the services sector in GDP has been rising, while that of agriculture has been declining steadily (Figure 3). The agriculture sector’s share of GDP declined by three percentage points between 2003/04 and 2008/09 and has now been surpassed by services. This impressive growth in services was driven by the rapid expansion in financial intermediation, public administration and retail business activities. These services sub-sectors grew by more than 10 percentage point in GDP share during the past five years.

Some analysts, in fact, are forecasting that the services sector will make up more than 50 percent of Ethiopia’s GDP in just two years time. On the other hand, the share of industry in GDP has remained relatively static, amounting to between 13 and 14 percent. The manufacturing sub-sector contributed less than 4 percent of GDP growth in 2008/2009. The low share of the manufacturing sector, a crucial sector in transforming an economy, is a concern for the Ethiopian Government.

Figure 3: Structural Composition of Economy



4. Growth and Poverty Reduction

The Ethiopian government attaches great importance to fostering rapid economic growth with equity. Indeed, acceleration in Ethiopia’s growth has been a key factor in the reduction in the incidence of poverty.

According to the 2004 Household Income and Expenditure Survey (HICES), the proportion of people below the poverty line at national level measured by the poverty head count index declined from 44.2 percent in 1999/00 to 38.7 percent in 2004/05.

Much of the decline in national poverty reported in the last HICES is attributed to a fall in headcount poverty in rural areas. A new HICES by the Central Statistical Authority that is currently underway is expected to show further declines in the poverty head count index.

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“In recent years, the government has adopted a robust growth and poverty reduction strategy, focusing on infrastructure development, commercialization of agriculture, improvements in access to basic services...”

“The concerted infrastructure push has been a particularly important factor in driving growth.”

5. Explaining Ethiopia's Recent Growth

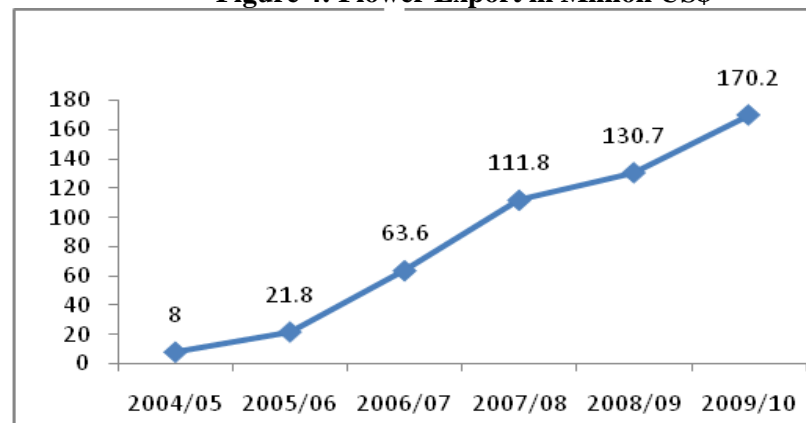
In addition to favorable weather conditions for agriculture during the last couple of years, several other drivers help explain Ethiopia's recent growth:

- **Conducive Government Policies:**

In recent years, the government has adopted a robust growth and poverty reduction strategy, focusing on infrastructure development, commercialization of agriculture, improvements in access to basic services, as well as on private sector development, including the creation of appropriate regulatory and institutional frameworks to support private business.

Business registration and licensing procedures and requirements have been streamlined, leading to a reduction in transaction costs. Improvements in policies along with major public investments in infrastructure have underpinned Ethiopia's recent growth in output and services, as well as the expansion and diversification of its exports. Incentives provided to new economic activities have started to yield results. The flower industry is a case in point. Flower exports have expanded from less than USD 10 million in 2004/05 to close to USD 170 million in 2009/10 (Figure 4). The success story of the flower industry could be replicable in other economic activities with export potential.

Figure 4: Flower Export in Million US\$



- **Heavy investment to address infrastructure bottlenecks:**

The concerted infrastructure push has been a particularly important factor in driving growth. Over the past five years, the Government and public enterprises have invested about US \$ 6 billion in roads, telecommunication, and energy sector. Those huge investments have led to a major expansion in infrastructure, albeit from a low base. For example, the power generation capacity has nearly doubled and the paved road network increased three-fold. Overall, the heavy public investment in infrastructure and social services has created a major expansion in domestic demand, raising overall growth.

- **Expansion of Exports and remittances:**

The country's exports have also been growing strongly, averaging about 25.1 percent per annum since 2003/04. While coffee remains the largest source of merchandise export earnings, non-traditional exports have registered faster growth. As a result, the share of non-coffee exports rose from 40 percent in 1997 to 65 percent in 2008. In this regard, the growing demand by China and India for Ethiopia's non-traditional exports, such as sesame and other oilseeds, has contributed to the country's output and export growth. Indeed, the continued rapid expansion of both these economies is likely to sustain the growth in Ethiopia's exports in the medium term.

“This surge in external aid, alongside improved domestic revenue mobilization, has enabled the Government to increase spending on infrastructure, thereby stimulating to growth.”

“A major challenge for Ethiopia is to sustain its current growth rate while ensuring that that growth is also dynamic. Agriculture remains the country's largest source of growth...”

Likewise, remittances and FDI have also been growing at an impressive rate. Net private transfers have increased by three-fold within the last five years, surpassing export earnings. Remittances by Ethiopians living abroad to relatives and investment in Ethiopia have also played a significant role in the surge in private transfer. Imports have been growing by about 20 percent per annum since 2003/04.

- **Increased public expenditure to enhance pro-poor growth:**

Public expenditure has been growing by about 19 percent per annum since 2003/04. The share devoted to pro-poor sectors in the total increased from about 26 percent in 1999/00 to about 43.3 percent in 2002/03 and 64 percent in 2008/09, up by 26.7 percent per annum since 2003. The public expenditure is concentrated in infrastructure and human capital development. In particular, there has been a major expansion in social services through the construction of new primary schools and health facilities.

- **Increased domestic revenue mobilization and aid:**

Government revenue has increased by about 21 percent per annum on average since 2003/04, even though revenue as a percentage of GDP has declined from about 23 percent in 2002/03 to about 12 percent in 2007/08. Tax revenue reached about 35.7 billion Birr in 2009/10 from about birr 11 billion in 2003/04, up by 37 percent per annum on average. At the same time, external aid volumes have increased in recent years, reaching USD 1.6 billion in 2008/09 from USD 0.9 billion in 2004/05. This surge in external aid, alongside improved domestic revenue mobilization, has enabled the Government to increase spending on infrastructure, thereby stimulating growth.

6. Challenges of Sustaining Growth

6.1. A major challenge for Ethiopia is to sustain its current high growth rate, while ensuring that that growth is also shared. Agriculture remains the country's largest source of growth. However, given the mounting pressure on land, sustaining higher rates of growth in agriculture production over the medium term will require substantial improvements in factor productivity. Consequently, transformation in the structure of production (which is mostly subsistence-based) to more commercially-oriented small-scale production, including for exports, will be key in sustaining growth. The Government's new five year development plan, currently preparation, is likely to have a major focus on commercialization of agriculture and development of agro business.

6.2. The industrial sector of Ethiopia is small and highly import dependent. In turn, this means that Ethiopia's high growth is still vulnerable to foreign exchange shortages. Diversification towards the industrial sector is thus key to sustaining high growth in the long run. This will require more private investment, in export oriented economic activities and in import substituting industries. Both of these require public investment in infrastructure. In recognition of this challenge, the Ethiopian Government's new poverty reduction and growth strategy includes a stronger policy focus on industrialization to support economic transformation. In this regard, the Government has also received capacity building support for the re-design of its industrial policy, including from the Government of Japan.