



THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

SELECTED ISSUES

October 2013

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THE FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

SELECTED ISSUES

August 29, 2013

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TRANSLATING ECONOMIC GROWTH INTO HIGHER LIVING STANDARDS: INCLUSIVE GROWTH IN ETHIOPIA

This paper reviews the extent to which growth in Ethiopia has translated into higher living standards, identifies key bottlenecks hindering further broadening of growth across key sectors to reduce poverty, and highlights the main areas for policy action. It is subject to two important caveats:

- *As for many low income countries, the analysis is constrained by limited, timely and detailed data availability on key metrics such as employment, household expenditure, income distribution, and other socio-economic indicators. In addition, available data, including on national accounts and household expenditures are subject to important weaknesses which the Ethiopian authorities are addressing. The note thus focuses on longer-term trends and the analysis is only suggestive and caution is warranted in drawing definitive conclusions.*
- *There is no consensus in the literature on the definition of inclusive growth. For the purposes of this paper inclusive growth is defined as growth which is high, sustained, broad-based across sectors, inclusive of a large part of the country's labor force, and which results in equality of opportunity—in terms of access to markets and resources—and enables sizeable increases in income and living standards of the majority of the population.¹ The definition suggests that both the pace and pattern of growth are critical for achieving a high and sustainable growth that translates into poverty reduction and is consistent with the findings of the Commission on Growth and Development (2008).² Indeed, inclusiveness encompasses equity, equality of opportunity, and protection in market and employment and is viewed by the Commission as crucial for any successful growth strategy.*

¹ Ianchovichina and Lundstrom (2009).

² Commission on Growth and Development, (2008), *Growth Report: Strategies for Sustained Growth and Inclusive Development*. The Commission also known as the Growth Commission was an independent body chaired by Michael Spence and brought together 22 policy-makers, academics, and business leaders to examine various aspects of economic growth and development. It was launched in 2006 to take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policymakers.

INTRODUCTION

1. In recent years, Ethiopia has sustained high growth spurred by bold national plans.

During 2005/06–2009/10, the Ethiopian government implemented the Plan for Accelerated and Sustained Development to End Poverty (PASDEP). In this period, the country achieved high economic growth with significant improvements in physical infrastructure and human capital resulting from public and private investments. The PASDEP has been followed by the Growth and Transformation Plan (GTP) spanning 2010/11–2014/15. The GTP is aimed at sustaining high and broad-based economic growth and achieving the Millennium Development Goal (MDG) targets by 2015. The longer term goal is to become a middle-income country by 2020–25.

2. A key feature of the economic strategy has been an explicit commitment to poverty reduction and structural transformation.

This is underpinned by the vision of a “developmental state”, whereby a proactive public sector leads the development process and the private sector is oriented to support the development goals. As a result, an economic structure has evolved where the public sector is deeply involved and state ownership is widespread in economic activities.

ECONOMIC GROWTH AND ASPECTS OF INCLUSION IN ETHIOPIA

A. Reviewing Key Outcomes

3. Robust economic growth in recent years has been accompanied by significant poverty alleviation (Figures 1 and 2).

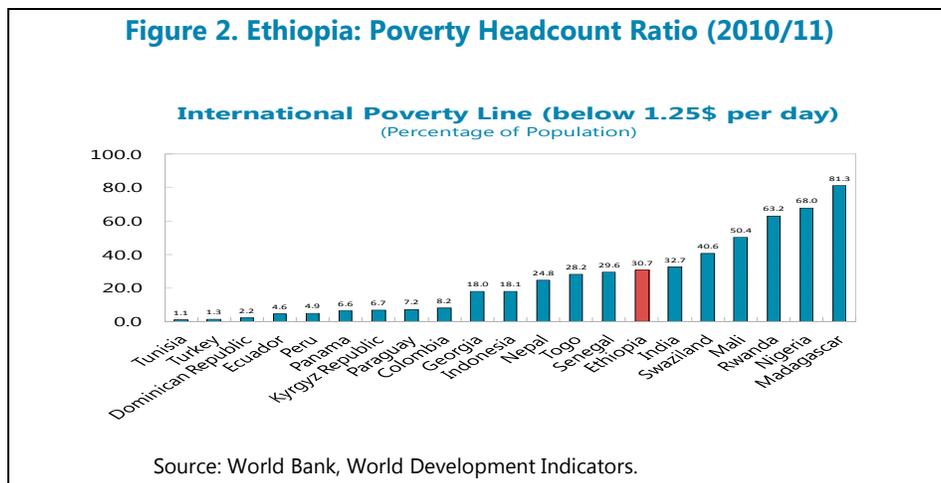
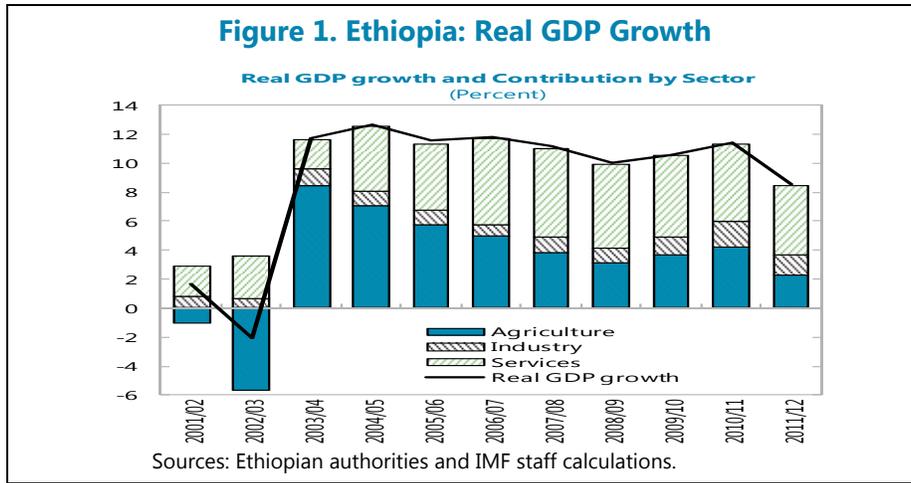
The proportion of people living below the poverty line—US\$1.25 a day purchasing-power parity adjusted—has gone down from 60.5 percent in 1995 to 30.7 percent in 2011. In comparison, estimates for sub-Saharan Africa—available through 2010—show a relatively modest decline, with the proportion of people living below the poverty line falling from about 60 percent in 1996 to 48 percent in 2010.³ Ethiopia has apparently outperformed many sub-Saharan African (and some non-African) countries regarding poverty reduction.

4. The quality of economic growth in terms of translating into improved living standards compares favorably with other countries.

An analysis of cross-country correlation between the annual change in the Human Development Index (HDI)—a composite statistic of life expectancy, education and income indices used as a proxy for living standards—and annual change in per capita Gross National Income (GNI) shows that Ethiopia has been more effective in translating economic growth into higher living standards. As shown in Figure 3, the upward trending fitted line indicates an overall positive correlation between economic growth and living standards. Ethiopia’s slightly positive deviation of the actual HDI from the fitted HDI (residual) indicates that the country has

³ Olinto Pedro and Hiroki Uematsu (2013).

managed to improve its population’s living standards by slightly more than would be predicted given its economic growth.⁴



5. Income distribution in the country is relatively even. Among sub-Saharan African countries, Ethiopia is one of the most egalitarian, with a Gini coefficient of 33.6 percent (Figure 4) and it has consistently maintained this distribution in the last ten years. With a large population and more than 80 percent of it in rural areas, Ethiopia stands out among comparable African countries regarding relatively even income distribution, although there are likely differences between rural and urban populations.

⁴ The cross-country regression is subject to the limitation that the elasticity is sensitive to the shape of the distribution of income per capita and the position of the poverty line with respect to the distribution.

Figure 3. Ethiopia: Growth and Living Standards

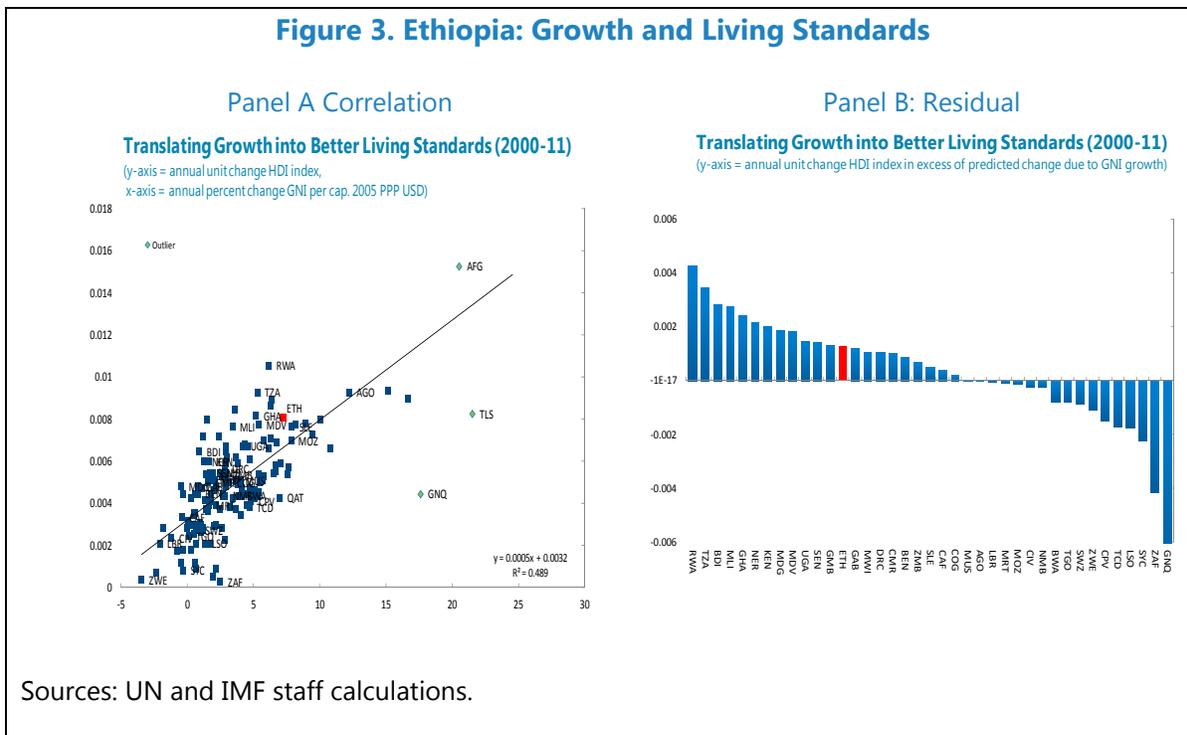
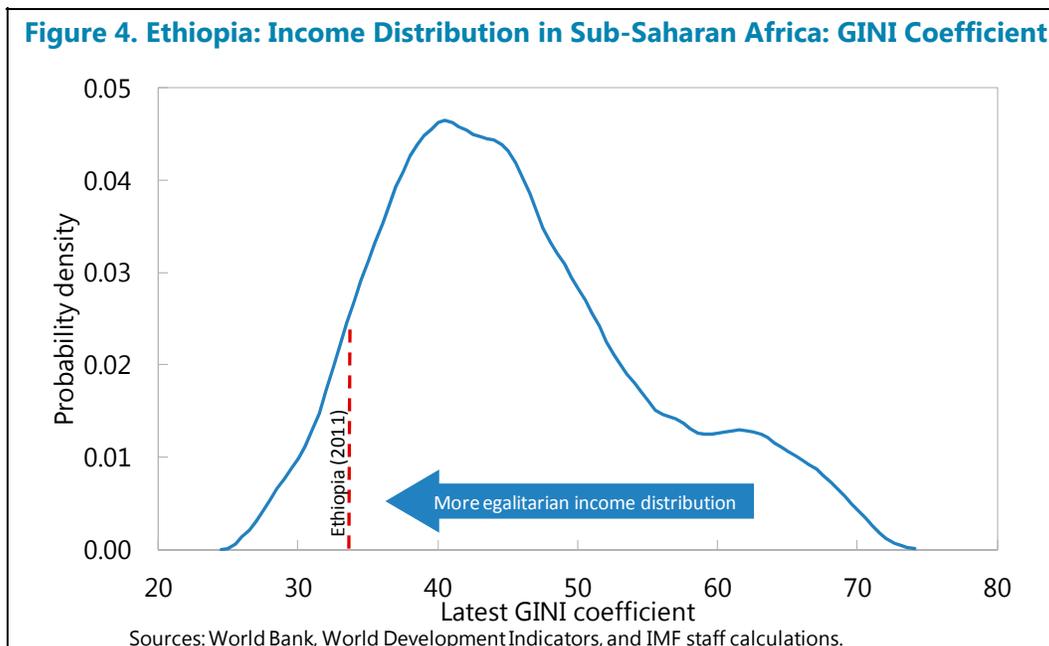
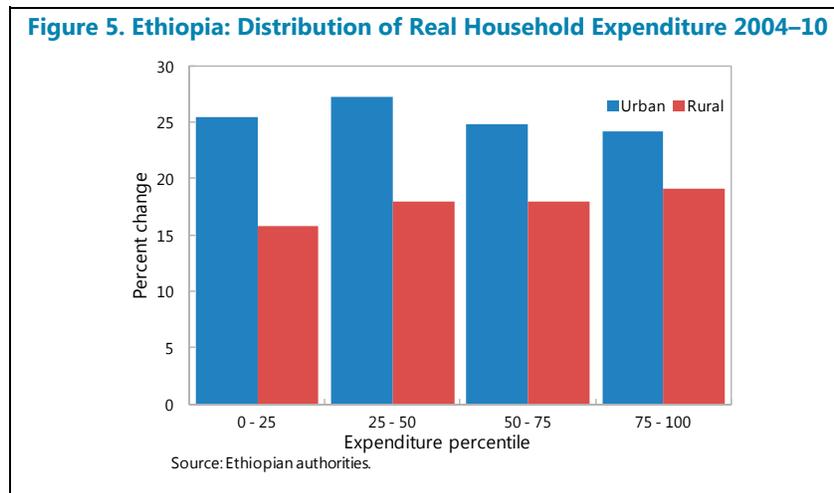


Figure 4. Ethiopia: Income Distribution in Sub-Saharan Africa: GINI Coefficient



6. The household survey data indicate improving capabilities across the population in recent years.⁵ The national literacy rate rose from 37.6 percent in 2004/05 to 48.3 percent in 2010/11, and the improvement spanned all segments of the population, males and females and urban and rural. The level of education (i.e., the share of household heads that have completed Grade 6) also rose not only nationally but also for all segments. Education attainment even just up to only Grade 6 is important it contributes to poverty reduction through for example better appreciation of primary health care, diversification into off-farm activities, use of factors for production beyond subsistence to generate surplus output. Literacy and the level of education are positively related to household expenditure: the better-off households (with higher expenditure) have a larger share of literate and educated heads of households. Attention is increasingly turning to improving the quality of education.

7. Overall, all households above the first income quintile experienced significant increases in consumption, while those in the lowest quintile benefited less.⁶ Poor households in urban areas have benefited the most from economic growth. Household surveys show that families in the lower income percentiles living in cities have increased their consumption expenditures by more than 25 percent from 2004 to 2010 (Figure 5). Consumption expenditure of rural households has also improved for all segments of income, but it was more pronounced for households in the middle to upper quintiles, suggesting that the poorest of the poor are yet to benefit to the same extent as the other segments of the population. This segment of the population is also more vulnerable to the vagaries of the weather, including droughts.

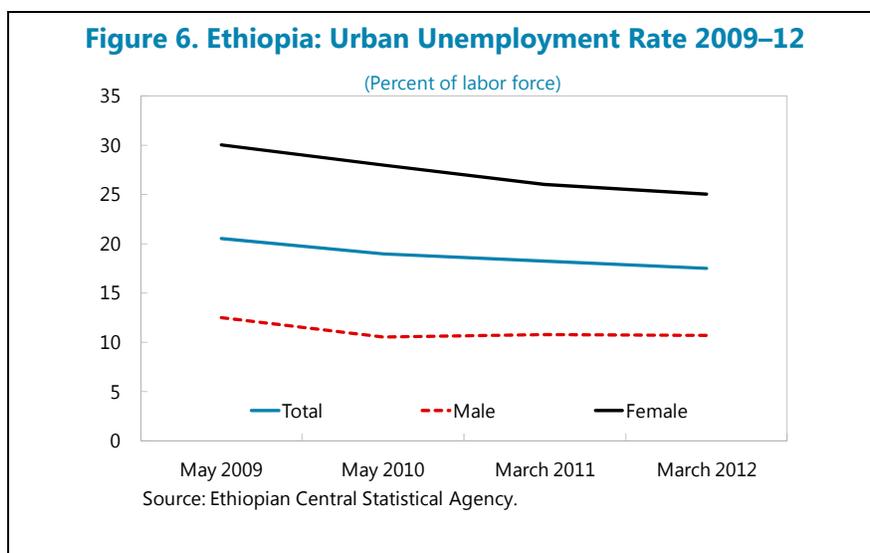


⁵ The 2010–11 household survey did not fully capture the impact on poverty and income distribution of the recent high inflation period.

⁶ The analysis here is based on Household Income and Consumption Expenditure Surveys that are conducted independently from the National Income Accounts and may also be subject to shortcomings.

8. Employment surveys in urban areas show encouraging trends (Figure 6 and Table 1).

The labor participation rate increased from 59.7 percent in May 2009 to 62.5 percent in March 2012, with the female labor participation rate showing a strong increase in 2012. During the same period, the unemployment rate declined from 20.4 to 17.5 percent, driven by a decline in female and youth unemployment. The share of informal employment also sharply declined in 2012 for both male and female workers, and total employment increased by 26 percent in three years in 2009 through 2012 and by 11 percent in 2012 alone.

**Table 1. Ethiopia: Labor Market Indicators in Urban Areas**

	May 2009	May 2010	March 2011	March 2012
	(Percent)			
Labor force/population aged 10 and above				
Total	59.7	59.4	60.3	62.5
Male	67.2	65.7	67.9	69.7
Female	53.1	53.7	53.5	56.2
Employment/population aged 10 and above				
Total	47.5	48.2	49.4	51.5
Male	59.0	58.5	60.2	61.7
Female	37.3	39.0	40.0	42.6
Informal sector employment/employment at firms				
Total	36.5	34.1	36.5	31.7
Male	30.5	28.3	28.0	24.2
Female	45.6	42.5	48.4	42.2
Unemployment/labor force				
Total	20.4	18.9	18.0	17.5
Male	12.2	11.0	11.4	11.4
Female	29.6	27.4	25.3	24.2
<i>Memorandum items:</i>	(Number of persons)			
Urban population				14,011,269
Urban population aged 10 and above				11,110,653
Labor force				6,944,691
Employment	4,547,266		5,139,813	5,726,116
Employment at firms 1/				5,152,260

1/ Excluding subsistence farmers and domestic paid workers
Source: Ethiopian Central Statistical Agency.

9. The performance of labor income indicates a somewhat ambiguous outcome. The share of wages and salaries rose in all but the 1st quintile and the share of agricultural production (self consumption and sales of own consumption) rose in the 1st and 2nd quintiles (Table 2). Although these trends are positive for households in these cohorts, they may also suggest that the relatively worse-off households are relying more on volatile own agricultural production and thus remain vulnerable.

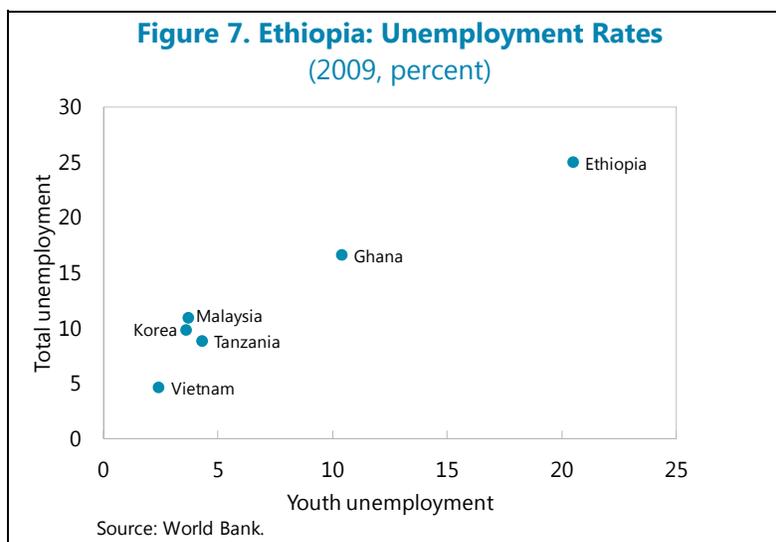
10. Job creation in urban areas has still not been rapid enough to boost employment across-the-board. The urban population (14 million in the 2012 survey) is relatively small compared to the total population (73 million in the 2007 census), and the pace of urban job creation (about four hundred thousand a year on average) does not appear strong enough to pull the rural population into stable jobs. It also remains to be seen whether the recent strong urban employment growth can be sustained.

Table 2. Ethiopia: Main Sources of Household Expenditure

2004/05		Quintiles					All
		1	2	3	4	5	
Total	All	100	100	100	100	100	100
	Rural	100	100	100	100	100	100
	Urban	100	100	100	100	100	100
Agricultural production	All	40	52	57	62	48	52
	Rural	46	59	65	70	70	65
	Urban	4	6	7	6	4	5
Non-agricultural enterprise goods and services	All	11	11	10	10	20	14
	Rural	8	8	7	6	10	8
	Urban	30	33	31	31	39	36
Wages and salaries	All	8	7	7	8	15	10
	Rural	5	4	4	3	3	3
	Urban	28	31	36	39	38	37
House rent including own dwelling	All	11	8	6	5	3	6
	Rural	12	8	7	5	3	6
	Urban	6	5	5	5	4	4
Remittances	All	15	9	7	6	5	7
	Rural	14	9	7	7	4	7
	Urban	19	14	11	10	6	9
Other	All	15	13	11	10	9	11
	Rural	15	13	11	9	9	11
	Urban	13	12	10	9	10	10
2010/11		Quintiles					All
		1	2	3	4	5	
Total	All	100	100	100	100	100	100
	Rural	100	100	100	100	100	100
	Urban	100	100	100	100	100	100
Agricultural production	All	47	55	56	55	42	49
	Rural	51	63	66	71	72	67
	Urban	3	4	6	7	6	5
Non-agricultural enterprise goods and services	All	9	8	10	11	19	13
	Rural	7	6	6	6	8	7
	Urban	26	25	26	24	31	29
Wages and salaries	All	6	8	10	12	20	14
	Rural	4	4	4	3	4	4
	Urban	25	30	33	39	38	37
House rent including own dwelling	All	11	8	6	5	3	6
	Rural	11	7	5	4	3	5
	Urban	5	10	11	11	10	10
Remittances	All	10	8	7	6	6	7
	Rural	9	6	5	4	4	5
	Urban	27	18	14	11	8	10
Other	All	17	13	11	11	10	12
	Rural	18	14	14	12	9	12
	Urban	14	13	10	8	7	9

Source: Ethiopian Central Statistical Agency

11. Despite substantial overall progress, significant room remains for further reducing poverty. More than 30 percent of the population still lives under the poverty line (US\$1.25 per day purchasing-power parity adjusted) and the share of economically active population excluded from participation in income earning economic activity is around 25 percent (Figure 7).



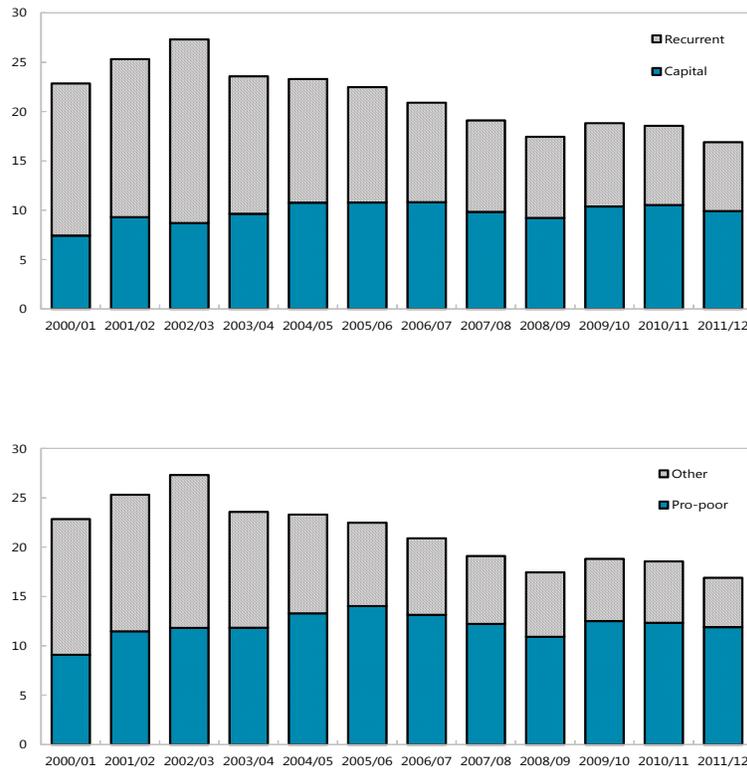
B. Inclusive Public Policy

12. The authorities emphasize their pro-poor policy focus. Fiscal policy has sought to promote both growth and equity through pro-poor spending. Data limitations prevent an analysis of the incidence of taxes for various income cohorts, but the heavy reliance on indirect taxes, which tend to be regressive, suggests scope for making revenue more equitable through increased share of direct taxes. Although income tax brackets are progressive within the direct taxes, changes to the overall tax regime in Ethiopia have to consider its implication for inclusive economic growth given its level of development. Overall, regarding revenue mobilization, Ethiopia remains behind its peers; and greater efforts in this area could support higher growth-promoting and social expenditure.

13. The emphasis on sharing the benefits of growth has been reflected in the structure of government spending. The authorities have kept public investment (capital expenditure) and pro-poor spending with respect to GDP at a relatively constant average of 10 and 12.4 percent respectively over the last 10-years (Figure 8).⁷ The key to achieving this outcome has been prioritization through the budgetary processes. The strong pro-poor focus has been instrumental in Ethiopia's progress toward the MDGs.

⁷ Pro-poor expenditure consists of education, health, agriculture, natural resources, and roads.

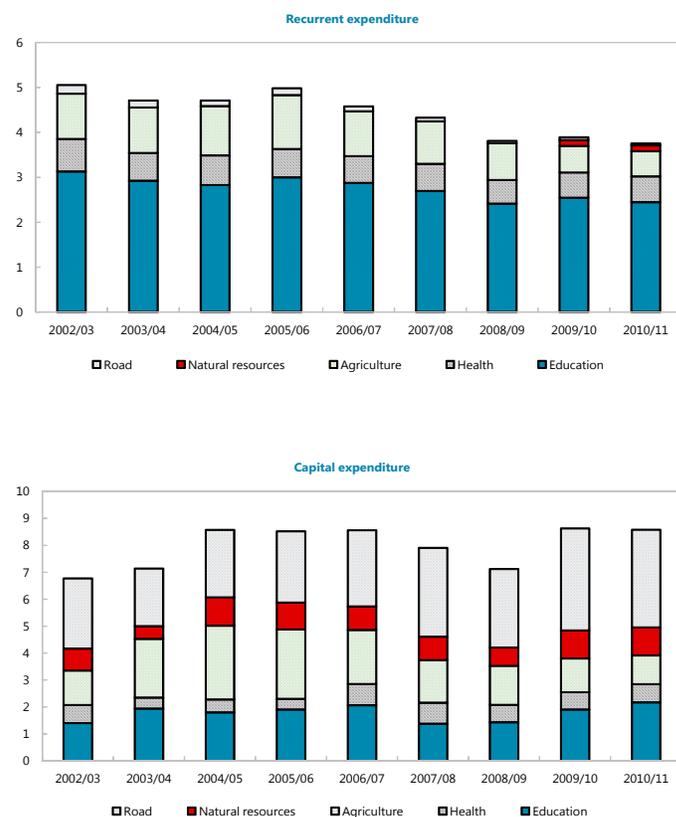
Figure 8. Ethiopia: Government Expenditure by Type, 2000/01–2011/12
(Percent of GDP)



Sources: Ethiopian authorities, and IMF staff estimates.

- 14. Within pro-poor spending, there has been a gradual shift from recurrent to capital expenditure (Figure 9), with the former declining across-the-board.** The decline in the ratios of current spending-to-GDP ratios in the education and health sectors likely reflects an erosion of real wages owing to high inflation rather than a reduction in the number of workers. The rise in pro-poor capital spending has been concentrated mostly roads sector. The heavy investment in roads has paid off as the total road length has increased by a third (from about 36 thousand kilometers to about 49 thousand during the PASDEP period), the road condition has improved (with the proportion of roads assessed as being in good condition having increased from 64 percent to 81 percent during the PASDEP period), and the access to all-weather roads has improved.

Figure 9. Ethiopia: Pro-Poor Expenditure by Function, 2000/01–2011/12
(Percent of GDP)



Sources: Ethiopian authorities, and IMF staff estimates.

15. The Ethiopian's Productive Safety Net Program (PSNP), the second largest social protection program in Africa, is contributing to addressing the poverty reduction challenge.⁸ PSNP is an innovative program that integrates income and employment through public works, with transfers to labor-constrained households. The program typically guarantees work and through that income to targeted labor-constrained households. In particular, eligible households must work for five days to receive the transfers for one person. The transfers generally take the form of a combination of food and cash, and the balancing of these two forms of payment is based on a number of factors. The program which started in 2005 with about 4.5 million beneficiaries now has

⁸ See Lieuw-Kie-Song, Maikel (2011) for details. The Child Support Grant in South Africa is the largest (in terms of the number of beneficiaries) social protection intervention in Africa, with more than 9 million beneficiaries and an annual budget of US\$5 billion.

about 8 million beneficiaries in about 1.5 million households, and has been crucial for poverty reduction.

16. Monetary policy has also been aligned with the developmental goals. Monetary expansion has sought to accommodate the needs of a growing economy with credit allocation supporting some priority sectors which are also labor intensive. The authorities have been cognizant of the deleterious effects of inflation on the poor and in recent years have implemented a tight monetary policy targeting base money growth consistent with single digit inflation.

17. Financial policies have sought to support developmental goals through various interventions. Real interest rates have remained negative and only recently approached zero and have artificially kept the cost of development expenditures low. At the same time, the dominant state-owned financial institutions—the Commercial Bank of Ethiopia (CBE) and the Development Bank of Ethiopia (DBE)—have directed credit toward public spending priorities. To the extent that directed credit has allowed access to finance across industries and geographical areas it may have contributed to broader inclusion but has also likely distorted credit allocation. The absorption of credit by the public sector has constrained its availability to the private sector and significant segments of the economy, particularly in rural areas, remain constrained by the lack of access to credit.

C. Financial Inclusion

18. Access to finance is mainly through the banking sector and to some extent the microfinance institutions; capital markets are yet to be developed. As of September 2012, the banking sector comprised 18 commercial banks and one state owned development bank. The 18 commercial banks include 2 state-owned banks, with one of them representing about 70 percent of all commercial banks' assets. Commercial bank branches numbered 1,257, with more than a third located in Addis Ababa alone. Rural areas access to finance is limited. At the same time, the population per bank branch was 63, 644. Despite the country's population of nearly 90 million, there are only 7.1 million deposit accounts, suggesting that less than 8 percent of Ethiopians have a bank account. The number of borrowers was a mere 112, 793 as of September 2012.

19. Microfinance institutions (MFIs) play an important role in channeling credits to the poor. Focus on pro-poor finance emerged in Ethiopia in 1994 when the authorities adopted microfinance as a prime component of their new economic development agenda. This followed the realization of the poor performance of the conventional banks in supplying suitable financial products for small farmers. In 1996, the National Bank of Ethiopia (NBE) developed a prudential regulatory framework for microfinance to supply financial services to the poor. In particular, the Microfinance Proclamation 40/1996 opened the possibility for the establishment of deposit-taking MFIs. Despite these efforts, as of end-June 2012, only 31 MFIs were providing financial services to 2.9 million clients. These numbers are insignificant in a country where about 80 million people have no bank account.

20. In addition to the MFIs there are the Savings and Credit Cooperatives (SACCOs), which also contribute to pro-poor financing. Their mode of operation requires that the members first save and that the SACCOs later provide loans. The urban SACCOs are primarily work-based cooperatives, comprising mainly low-income segments of the population. They play a key role in urban poverty alleviation. The rural SACCOs are usually small grassroots-based and semi-formal financial institutions with about 50 to 200 members. They are growing in number, but their coverage remains insignificant relative to the size of the unbanked population.

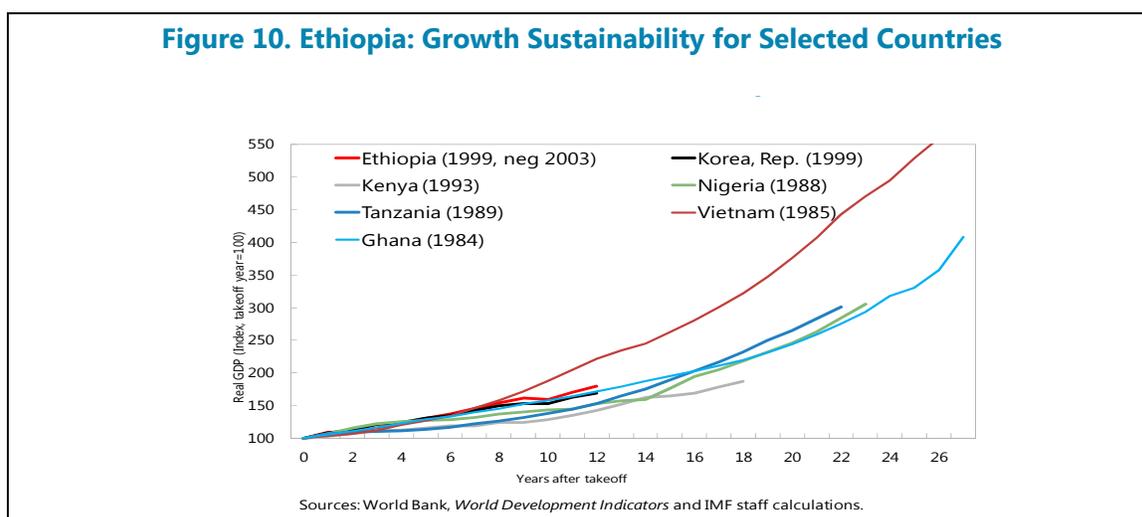
D. Inclusion of the Private Sector

21. The dominance of the public sector has meant that the private sector has not contributed as much as it could in the growth process. Although a significant share of economic activity takes place in the private sector (e.g., in the services and agricultural sectors), in a number of important areas, such as finance, communications and trade logistics, state-owned enterprises either enjoy monopolies or other advantages. The potential contribution of the private sector has been an under-appreciated aspect of inclusion in Ethiopia's development strategy.

CHALLENGES FOR GROWTH AND INCLUSIVENESS

A. Growth Sustainability

22. While economic growth has been high since 2004, this is a relatively short period. According to the Commission on Growth and Development, cases of successful inclusive growth tended to span a significantly longer period of sustained growth, approximately three decades. Figure 10 highlights the number of years of positive real GDP growth after a takeoff year—defined as a year followed by at least three years of positive real GDP growth. Growth in Ethiopia was fairly high until 2001 but displayed some volatility in 2002–03 before resuming in 2004. Ethiopia's experience with high growth is more recent compared to selected countries, for example Ghana, (since 1984), Vietnam (since 1985), Nigeria (since 1988), and Tanzania (since 1989).



B. Composition of Growth

23. Growth has been dominated by two sectors—services and agriculture. The shares of the labor-intensive agricultural sector and the services sectors have increased since 2000 (Table 3). The share of forestry, which also absorbs a fair amount of labor, displayed a steep declining trend. At the same time the share of manufacturing has also fallen. The composition of economic growth seems insufficiently broad-based to bring about rapid structural transformation. The implication of a growing share of the service sector in the economy (most likely concentrated in urban areas) for employment, income distribution and the diversification of the economy and inclusion more broadly deserves further analysis.

	<u>2000/11</u>	<u>2005/06</u>	<u>2011/12</u>
Services sector	40.3	40.2	41.9
Agriculture	41.6	43.4	45.1
Mining	0.6	1.4	1.6
Manufacturing	5.7	4.5	3.6
Construction	4.5	5.7	4.0
Utilities	2.2	1.9	1.1
Forestry	6.0	4.5	3.6

Source: IMF staff calculations.

C. Greater Role for the Private Sector

24. The gains on inclusion and poverty reduction thus far are largely owing to heavy public spending. For these to be enduring, the authorities will need to seek a different balance between the public and private sector to allow for broader access to factor and product markets by a wider set of economic agents. In particular, the involvement of the public sector in productive activities and credit allocation may need to be circumscribed and its investment profile made consistent with sustainable financing and the avoidance of crowding out of the private sector.

25. There is scope to further harness the transformational power of the private sector to generate employment and sustain development. Opportunities for the private sector are an important dimension of inclusion. With its strong trade and investment capabilities the sector could be a strong engine for creating employment and opportunities for the youth. Fostering greater competition, encouraging foreign direct investment, gradually withdrawing the public sector from areas where the private sector could be in the lead, and creating a supportive business environment through public-private dialogue to better understand the needs of the private sector could go a long way in developing a strong and vibrant private sector to help sustain growth and attain middle income status.

D. Business Climate, Governance and Transparency

26. According to the World Bank's Doing Business Indicators, the business climate in Ethiopia has worsened over the period 2008 to 2012, as highlighted in Figure 11, with the country's ranking declining from 102 (out of 178) to 111 (out of 183). In 2013, the business climate worsened further, with the ranking declining to 127 out of 185 countries. On specific dimensions, while Ethiopia fares better than SSA average regarding government effectiveness and is at par with regard to rule of law, the country compares unfavorably with the SSA average on corruption control and regulatory quality. It also ranks markedly below other regional averages (Table 4).

	Corruption Control	Rule of Law	Regulatory Quality	Government Effectiveness
Western Hemisphere	3.4	3.3	3.4	3.4
Asia and Pacific	3.3	3.3	3.3	3.4
Middle East and central Asia	2.8	2.8	2.8	2.9
Europe	3.9	4.0	4.1	4.0
Sub-Saharan Africa	2.7	2.6	2.7	2.6
Ethiopia	2.6	2.6	2.3	2.9
Low Income Countries	2.4	2.3	2.4	2.3

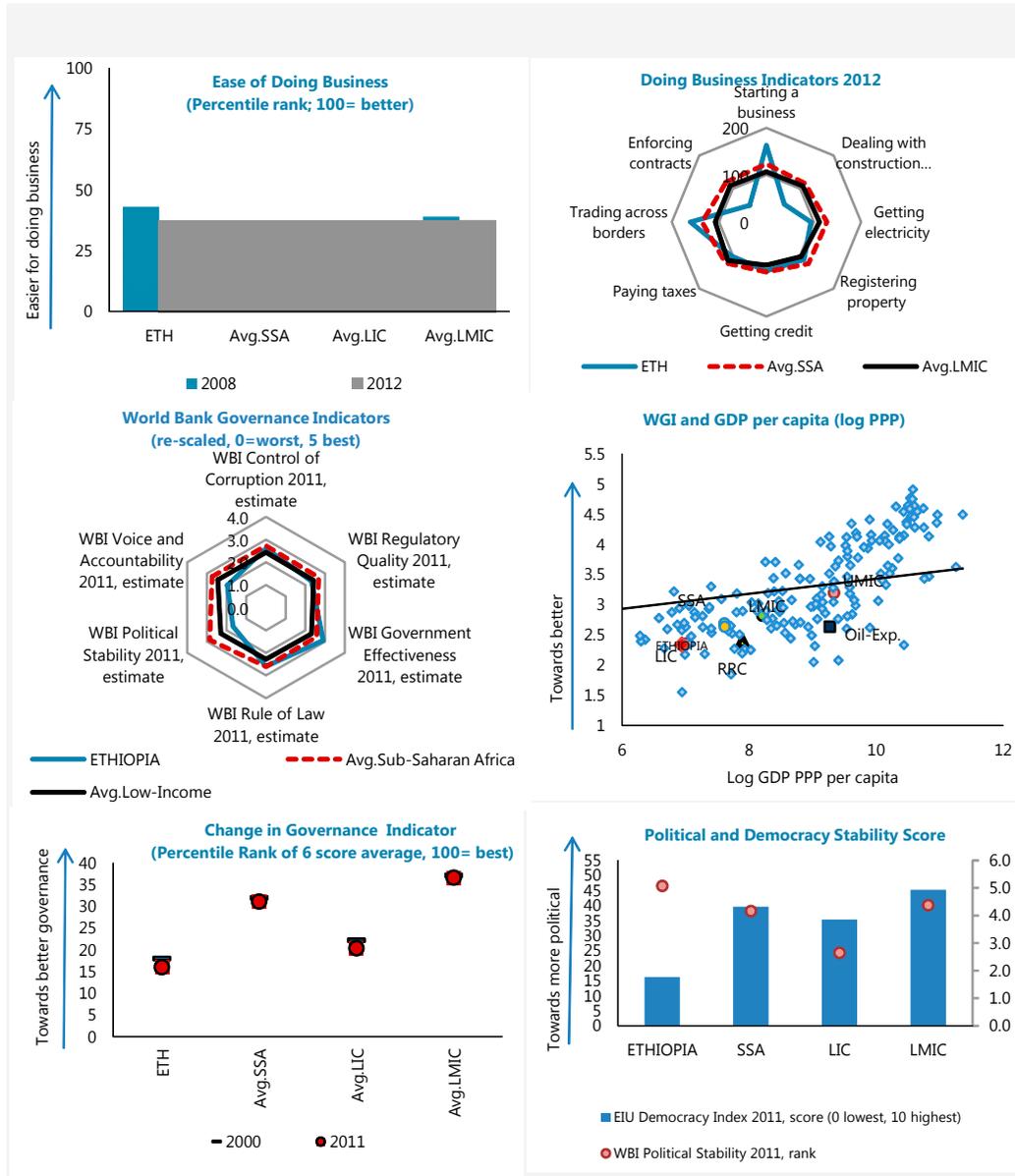
Source: Computed based on World Bank Institute Governance Indicators (2011). All indicators were re-coded to range between 0 and 5.

E. Informal Economy

27. The informal economy in Ethiopia is estimated at about 38.6 percent of GDP compared with an average of 38.4 percent for SSA and 38 percent for all low-income countries.¹⁰ As in many other low-income countries, registration of informal economic units in Ethiopia is low, and as a result most of them remain outside the purview of government policies, especially with respect to labor and taxation. Figure 10 indicates weaknesses in the institutional framework, regulatory quality, and the rule of law. Such weaknesses typically incentivize micro-businesses to keep their activities out of the formal sector and they might be a factor underlying the sizeable underground economy in Ethiopia. High costs of registration are also among the factors contributing to economic activities remaining informal.

¹⁰ Schneider, Buehn and Montenegro (2010); Alm and Embaye (2013). Underground economy consists of various activities ranging from unreported economic activities by paid domestic works or house maids to registered business men that underestimate their production. It comprises all currently unregistered economic activities that contribute to the officially calculated gross national product.

Figure 11. Ethiopia: Business Environment and Governance

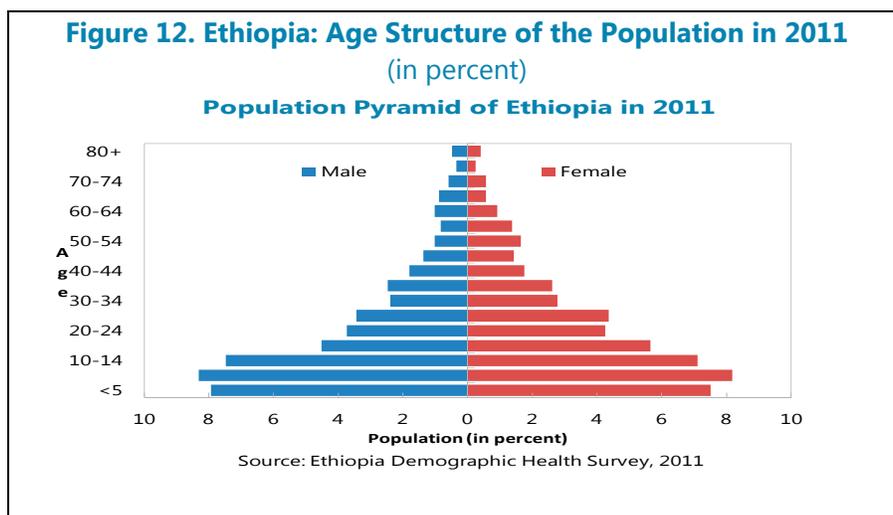


Sources: *Doing Business, 2012*; World Bank's *Governance Indicators, 2011*, (average of control of corruption, government effectiveness, rule of law, regulatory quality, political stability and voice and accountability); Economist Intelligence Unit (EIU); and IMS staff calculations.
 SSA = Sub-Saharan Africa; LIC=Low-income country; HIC= High-income countries; UMIC= Upper-middle income country; LMIC= Low-middle-income country; OIL=Oil producers; RR= Resource-rich countries; = ; WBI= World Bank Indicators.

F. Employment

28. Despite Ethiopia's high and sustained growth over the past nine years, unemployment remains high and tackling it is likely to remain challenging. Pressures in the labor market are likely to continue over the medium term because of:

- **Demographic dynamics.** The young population (under age 24) represents 65 percent of the total population, and increasing labor force participation rates lead on average to 1.2 million new job seekers each year, corresponding to about 3.2 percent annual growth in the labor force (Figure 12).¹¹
- **Skills mismatch.** A labor skills mismatch—resulting from an education system that is inadequately focused and responsive to the needs of the growing sectors—leads to high unemployment and under-employment, especially among youth.
- **Lack of job opportunities in labor-intensive sectors.** The relatively limited growth in the agricultural sector complicates prospects for new job seekers and increasing the rate of return in the agricultural sector could mitigate this challenge. The need to develop labor-intensive industries such as tourism, and garments-textiles, to create employment opportunities remains pressing.



¹¹ Total labor force comprises people ages 15 and older who meet the International Labor Organization definition of the economically active population: all people who supply labor for the production of goods and services during a specified period. It includes both the employed and the unemployed. Although national practices vary in the treatment of such groups as the armed forces and seasonal or part-time workers, in general the labor force includes the armed forces, the unemployed, and first-time job-seekers, but excludes homemakers and other unpaid caregivers and workers in the informal sector.

29. Access to Finance. Credit-providing institutions provide access to finance to only a small proportion of the population. This is an important constraint on the creation of productive employment, to inclusive growth and poverty reduction. It is also related to the broader issues of promoting domestic savings and resource mobilization discussed below.

NEED FOR RESOURCE MOBILIZATION

30. High and sustained growth over a long period (about three decades) is essential for inclusive growth. Sustaining high rates of growth, in turn, requires substantial levels of physical capital accumulation which necessitates reliance on external savings. However, with binding external financing constraints at appropriate terms, domestic savings need to finance aggregate investment. Accordingly, domestic savings are highly important for sustaining growth in Ethiopia and requires accessible, diversified, and safe saving instruments. Currently the main existing saving instruments in Ethiopia are deposits in banks or MFIs, pension or provident funds, insurance, T-bills, government bonds, and corporate bonds.

31. Resource mobilization through banks and MFIs. As of June 30, 2012, total deposits in the banking sector stood at birr 187.3 billion (25 percent of GDP), of which birr 92.2 billion (12.5 percent of GDP) are demand deposits, birr 82.5 billion (11 percent of GDP) were savings deposits, and birr 12.5 billion (1.6 percent) were time deposits. 68 percent of these deposits were collected by state-owned banks and 32 percent by private banks. Over the same period, MFIs collected birr 5.4 billion (about 1 percent of GDP) in saving.

32. Resource mobilization by pensions and insurances. Capitals or funds mobilized through pension or provident funds and insurance companies appear modest mainly because of the small coverage. As of June 30, 2012, there were 15 insurance companies, with 243 branches and total capital of birr 1.2 billion. Out of the 243 branches, 129 (53 percent) are located in Addis Ababa, highlighting the high concentration of these companies.

33. T-bill, government bond and corporate bond markets. Significant resources are mobilized through the T-bill, government bond and corporate bond markets; but their reach is limited. Participants in these markets are mainly banks and other institutional funds such as insurance companies or pension funds. The minimum denomination for bonds (birr 2 million) makes them beyond the reach of most individual savers. The two years maturity, combined with the absence of a secondary market, makes the bond markets illiquid and unattractive, because investors have to hold the bonds until maturity. For the T-bill market, relatively large denominations (birr 5000), uncertainty of being able to win in a tender, and the negative real rate of return make this market less attractive to individual savers.

34. Domestic savings in Ethiopia fall far short of what is needed to finance investment and sustain growth for a long time. The domestic financing gap for Ethiopia is very large (Table 5). While the average financing gap was about 9.4 percent of GDP in 1990–2000, it widened to about 17 percent in 2006–12. In sub-Saharan Africa, this gap on average is much smaller, about 6 percent.

The large gap in Ethiopia mainly reflects the very high investment levels envisaged the development plans.

	1990– 2000	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Gross domestic saving	5.0	8.7	5.2	5.7	5.2	8.8	13.9
Gross domestic investment	14.4	22.1	22.4	22.7	24.7	25.5	32.3
Resource gap	-9.4	-13.5	-17.1	-17.0	-19.5	-16.7	-18.4

Sources: Ethiopian authorities and IMF staff calculations.

AREAS FOR POLICY ACTION

35. Sustaining the progress to date, removing growth bottlenecks, and further improving the living standards of the majority of the population requires action to foster domestic savings and on a number of fronts. The latter include (i) providing incentive for the emergence of a wide range of activities capable of creating jobs for high-skilled and low-skilled workers; (ii) undertaking deep reforms aimed at creating a business-friendly environment, in particular by strengthening the regulatory framework, and promoting access to financing; (iii) introducing structural improvements to alleviate credit constraints and trade related restrictions; and (v) providing opportunities for the private sector to leverage the large public investment.

36. Strengthening tax revenue mobilization efforts. The role of fiscal policy in increasing domestic savings needs to be focused on raising revenue. As indicated above, there is room for stronger government revenue performance. For example, tax revenue to GDP ratio is about 16 percent in sub-Saharan Africa and above 25 percent in emerging markets. In Ethiopia, this ratio is about 12 percent, suggesting significant room for improvement.

37. Increasing private savings may require a combination of both legislation and incentives tailored toward improving availability and returns on existing financial instruments as well as introducing new instruments.

38. Banks and MFIs: The authorities should encourage banks and particularly MFIs to increase their outreach by opening up the banking and MFI sectors to institutions willing to participate and by providing an appropriate regulatory environment for such institutions. Easy access to convenient and safe saving vehicles can raise savings significantly. Most bank branches are currently concentrated in urban towns, particularly in Addis Ababa, while a large proportion of the population lives in rural areas and, lacks access to financial instruments. The promotion of financial instruments that suit the needs and preferences of rural savers is vital for generating and mobilizing savings.

39. Mobile banking: Appropriate legislative and regulatory provisions to introduce mobile banking can help expand financial inclusion. This would entail allowing the entry of non-bank mobile money providers, including mobile network operators (MNOs) into the Ethiopian market. Experience elsewhere suggests that mobile banking can significantly expand financial inclusion through lower transaction costs, better access to underserved areas, and customer convenience. With only one MNO, the Ethio Telecom, Ethiopia counts about 17 million cell phone users, which could have immediate access to finance through mobile banking compared to the current 7.1 million bank accounts. According to Ethio Telecom, the number of cell phone users is expected to reach 40 million in the next three years, which could significantly expand financial inclusion if mobile banking were introduced. The authorities' engagement with BelCash and M-Birr, two mobile banking technology providers, is a move in the right direction. Such a development would also provide a platform for other financial service providers to leverage on to reach out to those currently financially excluded.

40. Insurance companies: Legislation may need to be enacted that will not only incentivize the emergence of more insurance companies, but also will increase coverage. Insurance is an important vehicle for promoting contractual savings and making resources available for long term lending. The insurance sector in Ethiopia is at a very early stage of development and is very profitable, recording a return on equity (RoE) of 35 percent and a return on assets (RoA) of 8 percent as of June 30, 2012. In the same period, insurance branch to population ratio stood at 334,608, suggesting that the industry has a large potential to grow and generate significant contractual savings.

41. Pension or provident funds: Appropriate legislation may need to be enacted to increase coverage of pension or provident funds which could further support greater savings mobilization. According to the 2002 Central Statistics Agency surveys, there were about 85,500 permanent workers in the large and medium scale manufacturing industries in Ethiopia, about 55,000 in small scale manufacturing industries, and about 1,231,000 owners of cottage or handcraft manufacturing industries. At the same time only about 500,000 workers (including civil servants) had pension or provident fund coverage, suggesting the potential for expanding coverage is considerable. The establishment in July 2011 of the Private Organization's Employee Social Security Agency (POESA) is a move in the right direction. Just in its first year of operation, POESA was able to collect more than 800 million birr, further illustrating the industry's huge potential to grow and generate savings.

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