I. INTERVIEW-IMF sees Ethiopia's economic growth slowing as private sector struggles

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* GDP growth seen slowing to 6.5 pct in 2012/13 from 8.5 pct

* Inflation seen steady in single digits

* Huge public spending crowding out the private sector

* Reforms needed to lure more foreign investment

By Richard Lough

ADDIS ABABA, May 23 (Reuters) - Ethiopia's huge public spending has created one of Africa's fastest-growing economies, but volatile inflation, balance of payments pressures and a stifled private sector raise questions over its sustainability, the International Monetary Fund said.

Ethiopia's 85 million-strong population, making it Africa's second-most populous nation, offers an attractive market with cheap labour for foreign investors.

Across the capital, mushrooming construction sites, glass-clad office towers and giant billboards showcasing hi-tech electronics point to Ethiopia's emerging middle class. But idle youths loitering on streets and impoverished slums underscore some of the challenges facing the government.

Economic growth will slow to an estimated 6.5 percent this fiscal year from 8.5 percent in 2011/12, Jan Mikkelsen, the IMF's country representative in Ethiopia, said in an interview on Thursday.

Massive energy, transport, IT and manufacturing projects require financing equivalent to roughly 15 percent of Ethiopia's estimated $33 billion annual national output. About half had to be domestically funded, Mikkelsen said.

"The amount of financing that those projects absorb is so large that it is crowding out activity in the private sector," said Mikkelsen, whose office overlooks a new superhighway running through central Addis Ababa.

Businesses struggle to access private credit and foreign exchange, curbing private sector activity and creating an imbalance between the private and public sectors.

"That imbalance is hurting growth over time and makes it more difficult to attract investors," he said, projecting growth would remain steady at 6.5 percent in 2013/14 as well.

Key sectors, such as banking and telecoms, remain firmly in government hands.

The government has reported double-digit GDP growth for much of the past decade, but some economists say that is inflated. The IMF's next annual review is due out in a month.

Growth has been driven by an expansion in services and agriculture. The main exports include coffee, horticultural products and livestock. Ethiopia is also a big aid recipient.

Addis Ababa's high public spending had fuelled volatile swings in inflation as the government bought hard currency, thereby flooding the market with liquidity.

Food and oil price shocks exacerbated swings that saw inflation scale 60 percent during 2008, fall into negative territory in 2009 before spiking above 40 percent in 2011.

FOREIGN INVESTMENT

That raised concerns regarding macro stability, Mikkelsen said. In the past 18 months, monetary policy has been tightened and the headline inflation rate slid to 6.1 percent in April.

"Our projection given the policy stance ... is that single-digit inflation will be maintained this year and next year," said Mikkelsen, adding this probably meant upper single digits.

The battle against inflation has been fought at the expense of the country's foreign exchange reserves, the main tool used by Ethiopia to mop up liquidity and which fell by some $1 billion between 2010/11 and 2011/12, according to the IMF.

At the start of this fiscal year running to July 7, reserves stood at about $2.3 billion, less than two months' import cover.

The government was on track to end the year with reserves steady, Mikkelsen said, but there are questions over how easily the government can sustain its spending programme while targeting single-digit inflation.

The Fund backs Ethiopia's efforts to build more roads and hydroelectric dams, but Mikkelsen said Addis Ababa could slow the pace of public sector investment to give private firms a bigger role, which would ease demand for domestic financing and attract foreign investors.

The state-owned Commercial Bank of Ethiopia controlled more than two thirds of the entire sector's assets in 2012, according to the IMF, while the only telecoms firm is state-run.

To lure foreign cash, Ethiopia needed to increase access to financial services, improve trade logistics and embrace private business as a force for development, Mikkelsen said.

"We think with the right policy close to double-digit growth is possible given the potential that is here in Ethiopia and given the interest that we see." (Editing by Edmund Blair and Susan Fenton)