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Eritrea: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Eritrea

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Eritrea, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 28, 2003,** with the officials of Eritrea on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 21, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 2, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Eritrea.

The document(s) listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ERITREA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Eritrea

Approved by Anupam Basu and G. Russell Kincaid

April 21, 2003

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Executive Summary

- A staff team consisting of Messrs. Riechel (head), Christensen, Yamauchi, Mercereau (all AFR) and Ding (TRE); and Ms. Kabia (Assistant, AFR) visited Eritrea during January 14–28, 2003 to conduct the discussions for the 2003 Article IV consultation.

- Donor assistance to Eritrea is limited to humanitarian assistance and support for demobilization as a result of political governance issues related to the imprisonment of dissidents and journalists and delays in the implementation of key constitutional provisions. A dialogue on these issues has resumed, with the aim of resolving them.

- Eritrea is confronted with a wide range of economic challenges, including drought management and macroeconomic stabilization in the short term, and the move toward a peacetime economy in support of sustainable growth over the medium term. The authorities are working hard to master these challenges but need both financial support and technical assistance to make substantive and steady progress.

- Given the severity of the drought, its effective management is the first priority of the authorities. However, with their draft budget for 2003, they are also making an effort to reduce the fiscal and external deficits of the country, which have reached unsustainable levels. Success with these endeavors depends crucially on the decisive implementation of the demobilization program for combatants.

- Monetary policy has been dominated by the large domestic financing needs of the government's sizeable fiscal deficits. A coherent framework of tighter fiscal and monetary policies is needed to reduce inflationary pressures. The current dual exchange rate system is a source of distortions and these need to be eliminated by moving to a unified exchange system. The authorities will need technical assistance from the Fund to design and implement the necessary reforms in these areas.

- In moving toward a peacetime economy, both structural reforms and sound macroeconomic policies will be needed in support of growth and poverty reduction. The role of government will need to be scaled down and reformed along with efforts to promote private sector development. Such a reform strategy should be developed through a broad-based consultation process and set out in a Poverty Reduction Strategy Paper (PRSP). In the latter context, steps should be taken to increase the availability of reliable information to the public to strengthen transparency and accountability.

- The authorities expressed a renewed interest in discussions on a program that could eventually be supported by the Fund. They recognized the need to establish a track record of policy implementation under a staff monitored program (SMP) to lay the basis for subsequent discussions on a PRGF arrangement.

I. Introduction

1. A mission[1] visited Asmara during January 14–28, 2003 to conduct the discussions for the 2003 Article IV consultation. The discussions took place at a time when Eritrea was experiencing the worst drought since its independence in 1993, and still suffering from the extensive destruction of infrastructure and widespread dislocation of large sections of the population that had resulted from the border conflict with Ethiopia during 1998–2000. In addition, the country faces large macroeconomic imbalances and a prolonged suspension of budgetary and balance of payments assistance from donors, owing to concerns about political governance. Donor concerns relate to the imprisonment of political dissidents and journalists, as well as to delays in granting the permission to establish political parties and hold the elections provided for under the 1997 Constitution. These concerns remain unresolved and have so far prevented the full reengagement of donors in the country, outside of humanitarian assistance and the financing of demobilization.

2. **The last Article IV consultation with Eritrea was concluded by the Executive Board on November 26, 2001.** At that time, Directors were encouraged by the progress in stabilizing and reconstructing the economy. They urged the authorities to restore relations with donors and move quickly to reach understandings on an economic program that could be supported by the Fund under its post-conflict emergency assistance policy. Directors underscored the importance of maintaining prudent fiscal policies, and encouraged the authorities to accelerate demobilization, with a view to curtailing military outlays and returning soldiers to the civilian workforce. Directors also emphasized the need to reduce the size of government and its involvement in the economy, especially in the banking sector, and to allow more competition in the foreign exchange market. Finally, they called on the authorities to remove serious statistical weaknesses that hampered analysis and decisions on economic and financial policies.

3. **Eritrea is an Article XIV member and has never had a Fund arrangement.** In June 2001, preliminary understandings were reached on a post-conflict program.[2] However, the discussions could not be concluded because the European Union (EU) withdrew its balance of payments support following a serious diplomatic dispute over political governance issues. Moreover, in October 2001 the authorities implemented a tax reform package that fell short of understandings reached with the staff during the program discussions. Together, these developments rendered the agreed macroeconomic framework untenable. The authorities have lately expressed a renewed interest in resuming discussions on an economic program that could be supported by Fund resources.

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[1] Consisting of Messrs. Riechel (head), Christensen, Yamauchi, Mercereau (all AFR) and Ding (TRE); and Ms. Kabia (Assistant, AFR). The mission met with Dr. Woldai Futur and Dr. Abraham Kidane, Economic Advisors in the Office of the President, Mr. Tekie Beyene, Governor of the Bank of Eritrea, Mr. Arefaine Berhe, Minister of Agriculture, and other high officials of the government and central bank.

[2] A summary of Eritrea's relations with the Fund and the World Bank Group is contained in Appendices I and II, respectively. A detailed discussion of statistical issues is presented in Appendix III, while a table on social and demographic indicators is provided in Appendix IV.

II. Recent Economic Developments

4. **The Eritrean economy, already among the economies with the lowest per capita income in the world,[3] continues to be adversely affected by the effects of the border conflict with Ethiopia.** Despite the two-year-old peace agreement, security concerns remain because the final demarcation of the border between the two countries is still outstanding.[4] Partly as a result of this, the authorities have slowed the implementation of the demobilization program, with adverse consequences for the fiscal position and for economic recovery and development. Reconstruction efforts have also been impaired by the prolonged suspension of critical donor assistance.[5]

5. **The pervasive drought dominated developments in both economic growth and inflation in 2002 (Box 1).** Real GDP fell by 1.2 percent in 2002, compared with an increase of 8.7 percent in 2001 (Table 1 and Figure 1). Mainly as a result of the drought, but also reflecting delays in demobilization and the demining of agricultural land, crop production is estimated to have fallen by 77 percent in 2002. Nonagricultural growth held up better and exceeded 6 percent, owing mainly to strong activity in the construction and trade sectors. Preliminary data suggest that inflation rose to almost 24 percent by end-2002, compared with 8 percent at end-2001.[6] Food prices increased by 18 percent, reflecting growing food shortages, while nonfood inflation increased to more than 30 percent, fueled by the large depreciation of the nakfa in the parallel market and strong growth in the monetary aggregates (Figure 2).

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[3] See Appendix IV.

[4] Ethiopia has challenged the recent decision of the UN-installed Border Commission on the border demarcation with Eritrea.

[5] Out of the US$244 million available for the Emergency Reconstruction Program (ERP), only US$79 million have so far been utilized. While the dialogue with the EU and other bilateral donors was resumed and resulted in an unblocking of part of the EU's demobilization assistance (€17 million out of €42 million), disbursements of budgetary and balance of payments assistance are conditional on satisfactory progress on the governance issues and a sound macroeconomic framework.

[6] There are significant differences between the consumer price data produced by the National Statistics and Evaluation Office (NSEO)and the Bank of Eritrea. The latter has estimated inflation at 34 percent during 2002. Part of the reason is the different weighting scheme. However, there are also significant differences in inflation for sub-categories of the index, e.g., clothing and footwear and transportation, where the BE measure was higher than the NSEO measure by 28 and 117 percentage points, respectively. In the past, no such differences were observed.

Box 1. The Drought and Its Impact

Causes

The current drought is the worst ever since the independence of Eritrea in 1993. An almost complete absence of rain has seriously undermined agricultural production, even in the most fertile areas of the country. The crisis has been aggravated by the continued mobilization of large numbers of farmers into the armed forces. In addition, sections of the most fertile land remain covered with mines from the 1998-2000 war.

Impact

Crop production dropped sharply in 2002 because of the drought. The harvest is estimated at 54,000 metric tons (MT), only about one-fourth of the average production over the past ten years. As a result, the overall food deficit is estimated at 476,000 metric tons of grain equivalent. Furthermore, drinking water has become increasingly scarce, and a considerable part of the livestock have died.

The drought is estimated to threaten the lives of over 1.4 million Eritreans, more than one-third of the population, according to a joint UN-government study. In addition, the large number of internally displaced people from the war, who are presently living in refugee camps, would need food and other humanitarian assistance. There are indications of growing malnutrition and subsequent death, especially among children.

The drought has also reduced the availability of seeds and is expected to affect the 2003 planting season.

Immediate response

In November 2002, **the government appealed for emergency food assistance,** supported by the UN Consolidated Inter-Agency Appeal.

Donor response has so far been weak. The combined support from the European Union (EU) and World Food Program (WFP) totals 78,000 MT, valued at about US$27 million. The U.S. Agency for International Development (USAID) has pledged, but not yet committed, an additional 35,000 MT, and the World Bank plans to provide about US$30 million in emergency assistance (equivalent to about 86,000 MT). Total donor assistance could then amount to 200,000 MT, leaving an unfinanced gap of 276,000 MT (equivalent to US$95½ million, or about two months of Eritrea's total imports of goods and services in 2002).

The authorities are preparing alternative ways to prevent starvation in case of insufficient donor assistance. The 2003 budget provides for ERN 300 million in contingency funding for emergencies (amounting to about 34,000–55,000 MT, depending on the exchange rate and food prices). Additional funds may be gained by cuts in other budgeted expenditures. However, the low level of foreign reserves constrains the use of such funds for purchases from abroad. As a last resort, the government stands ready to borrow abroad, preferably on concessional terms, to avoid the starvation of the population.

Tackling chronic food insecurity

The government of Eritrea is working on a medium-term food security strategy to tackle the country's chronic food deficit. This strategy includes, inter alia, strengthening water catchments and irrigation systems, enhancing the productivity of rain-fed agriculture, and increasing livestock and fish production.

Food production and security are also expected to benefit from demobilization and demining. Over the next year, more than 130,000 persons are expected to be demobilized, many of whom will return to agriculture. The increase in arable land as a result of demining will also help boost production.

6. **Fiscal policy in 2002 turned out to be much less expansionary than foreseen under the approved budget, but covering the government deficit required a large increase in domestic financing.** A highly expansionary budget for 2002 was approved in February and envisaged an overall fiscal deficit, including grants, of close to 50 percent of GDP. The budget called for a large expansion of capital expenditures to reconstruct the economy and assumed substantial amounts of both domestic and foreign financing. In the event, the overall deficit, including grants, amounted to some 30 percent of GDP, compared with 35 percent of GDP in 2001 (Table 2 and Figure 3). The decline in the overall fiscal imbalance reflected, above all, a sharp reduction in capital spending that became necessary as a result of lower external financing. At the same time, the domestic fiscal deficit, which may better reflect the impact on domestic resources, remained essentially unchanged, at 21 percent of GDP. Revenue performance strengthened following the reform of the tax system and improvements in tax administration (Box 2). Some progress was also made in public expenditure management (Box 3), but current expenditure exceeded budgeted figures by about 7¼ percent of GDP, mainly because of delays in demobilization and a doubling in allowances for combatants and people in the National Service.

7. **Given the lower-than-expected external financing, the government's recourse to domestic financing amounted to some 20 percent of GDP in 2002.** As a result, the domestic public debt to 123 percent of GDP, while the external public debt rose to over 78 percent of GDP, mainly as a result of the depreciation of the nakfa (Figure 7). The net present value (NPV) of external debt stood at about 200 percent of exports of goods and services in 2002,[7] while external debt service rose from 5 percent of exports of goods and services in 2001 to 15 percent in 2002. Eritrea remains current on its amortization and interest payment obligations to official creditors. However, only US$3.7 million out of the US$18.2 million in scheduled amortization of debt to the diaspora[8] was repaid while the rest was rolled over. In addition, Eritrea negotiated a rescheduling agreement with the Abu Dhabi Fund in 2002.

8. **Monetary policy has been driven by the pressure to cover the financing needs of the government.** Broad money increased by 18½ percent in 2002, fueled by a strong expansion of credit to the government (Table 3 and Figure 4). Interest rates remained generally stable in nominal terms, but real interest rates turned increasingly negative as inflation accelerated. Monetary conditions were eased at the end of 2002 as the Bank of Eritrea (BE) reduced reserve requirements from 20 percent to 10 percent of local currency deposits. Simultaneously, as a prudential measure, the BE introduced a liquid assets ratio of 10 percent of banks' deposit liabilities in the form of unencumbered government securities (most banks were already in compliance with this requirement).

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[7] Excluding official gold exports, the ratio would have been 260 percent.

[8] The term "diaspora" is used for the large community of Eritreans living abroad but maintaining close ties to their families and the country.

Box 2. Reforms of Tax Regime and Tax Administration

Tax regime reform

Eritrea's tax regime has been greatly streamlined in recent years. In March 2000, the Fiscal Affairs Department (FAD) of the Fund made a set of recommendations on the reform of the tax system that covered every aspect of the tax regime, including income tax, sales tax, excises, and customs. In October 2001, the authorities implemented, with the support of a Fund resident advisor, a tax reform package that was mostly in line with the FAD recommendations. The measures implemented include the following: (i) a single rate structure was applied to employment, rental, and unincorporated business income, and the number of income tax rates was reduced from eight to five; (ii) the corporate income tax was unified at a flat rate of 30 percent, replacing the four rates previously used; (iii) the number of sales tax rates was reduced to three (0, 5, and 12 percent) from four (0, 3, 5, and 12 percent); and (iv) the number of customs tariff rates was reduced from twelve to three, with the maximum rate cut to 25 percent from 200 percent.

Unlike initially intended, the tax reform did not turn out to be revenue neutral. While the authorities had in principle agreed on the revenue-neutral recommendations of FAD, a critical component, the sales tax on petroleum products, was left unchanged (FAD had proposed that the specific taxes on gasoline and diesel be raised to 40 percent and 25 percent of the retail prices, respectively, from 21 percent and 7 percent). In addition, the rate of the sales tax on domestic goods was not raised, and, contrary to what had initially been agreed, the maximum customs tariff rate was reduced to 25 percent, instead of the proposed 40 percent. The staff estimated the revenue loss owing to these deviations from the initial tax reform proposal at 3.5 percent of GDP in 2002.

Tax administration reform

Tax administration has significantly improved over the last two years. FAD made a set of recommendations in April 2001 on a strategy for strengthening revenue administration, both for inland revenue and customs. While a part of the recommendations have not yet been implemented, the authorities started strengthening other aspects of tax administration with the support of Fund resident advisors. Reforms implemented were the following: (i) a Large Taxpayers' Unit (LTU) was established; (ii) self-assessment by taxpayers was introduced both in inland revenue and in customs operations; (iii) computerization was completed except for regional offices; (iv) a taxpayer identification number (TIN) is being introduced; (v) two branches were established in Asmara, in addition to the Inland Revenue Department headquarters office; (vi) the Inland Revenue Department was restructured according to a taxpayer-based, instead of a tax-based, organization, and (vii) heavier penalties for tax evasion are being introduced. The authorities are of the view that the improvements in tax administration and the new streamlined tax regime have strengthened tax collection and resulted in an effective self-declaration process.

Box 3. Public Expenditure Management

In April 2001, the Fiscal Affairs Department (FAD) prepared a set of recommendations to improve public expenditure management. The recommendations included in particular the following: (i) adopting a comprehensive Organic Budget Law; (ii) preparing and publishing an annual budget; (iii) implementing a better cash management and expenditure control system; (iv) rationalizing government accounts and banking arrangements; (v) improving fiscal reporting, accounting, and information systems; (vi) strengthening auditing; and (vii) expanding training. To help with the implementation of these recommendations, a Fund resident treasury advisor assisted the authorities for six months in 2002.

Implementation of the recommendations has been slow, owing largely to the lack of capacity in the Ministry of Finance. Measures taken so far include the following:

- An Organic Budget Law has been drafted but not yet enacted.
- An annual budget preparation process in line with the recommendations was broadly followed in 2002 in the context of the 2003 budget. A budget preparation manual is being drafted.
- A Cash Management Unit was established to reduce the idle cash balances held in bank accounts of budgetary units. Quarterly cash plans are being introduced in 2003, and monthly cash releases will be made in conformity with quarterly projections.

Priority actions for the future include the following:

- establishment of a firm and comprehensive commitment recording and control system;
- identification of government bank accounts at all levels, reduction of their number, and a shift to end-of-day balances of zero for regional treasury offices;
- establishment of monthly fiscal reporting, with a variance analysis relative to the budget;
- budget reclassification along the lines of the IMF's *Government Finance Statistics Manual;*
- review of the system for internal and external audits; and
- stepping up of internal training.

9. **As part of its efforts to strengthen banking supervision, the Bank of Eritrea conducted in 2002 its first on-site inspections of the loan portfolios of the three domestic banks.** The inspections were assisted by a resident advisor from the Fund's Monetary and Exchange Affairs Department (MAE) and revealed that the Commercial Bank of Eritrea (CBE) and the Housing and Commerce Bank of Eritrea (HCBE) carried significant amounts of nonperforming loans, mostly because of the effects of the recent war and its aftermath.[9] The inspections also revealed several problems with the management and administration of banks, including in particular (i) a lack of adequate guidance from the bank boards; (ii) inadequate lending policies and procedures; (iii) deficient credit administration; (iv) inadequate provision for loan losses; and (v) a lack of adequate internal control systems. The banks were instructed to develop action plans to implement the recommendations contained in the inspection reports. Currently, external audits of the banks are being conducted, to be followed by full-fledged on-site inspections. In the interim, additional efforts are being made to strengthen the data reporting system for effective off-site surveillance of banks.

10. **Despite some improvement, the external current account deficit remained at an unsustainable level in 2002, especially in light of the extremely low level of official reserves.** Excluding official transfers, the deficit fell to 28 percent of GDP from 35 percent in 2001, while the deficit, including official transfers, declined by 3 percentage points to 15½ percent of GDP (Table 5 and Figure 5). These improvements were possible in part because of gold sales by the BE in the open market amounting to US$10.3 million, or 1.6 percent of GDP.[10] At the same time, official transfers declined sharply from US$121 million in 2001 to US$80 million in 2002, reflecting donors' concerns about political governance. As a result, gross international reserves of the central bank declined by almost US$18 million to US$33 million, or to less than one month of imports of goods and services by end-2002.

11. **In the foreign exchange markets, the differential between the parallel market and the official rate has risen markedly, because of the precarious international reserves position and the virtual fixing of the official exchange rate.** Increasingly, official transactions (and other priority needs)[11] are being conducted in the official market, while the vast majority of private transactions, including bona fide current transactions, are being channeled through the parallel market. Parallel market transactions are now operated by both officially licensed foreign exchange bureaus and "free" traders. While the official rate has been kept largely unchanged at some ERN 14 per U.S. dollar since September 2001 (Figure

[9] No information was released on the amount of nonperforming loans because there is an apparent dispute between the banks and the BE about the definition and classification of these loans.

[10] The gold was counted as part of official reserves of the BE. Because the sales took place in the open market, they are counted as exports.

[11] A national committee decided that these priorities should include food, medicines, petroleum products (critical for transportation), and capital goods.

6), the rate in the parallel market, which is broadly determined by market forces, has moved up lately to between ERN 22 and ERN 24 per U.S. dollar, implying a discount of 60–70 percent.[12]

12. **In the context of their structural reform effort, the Eritrean authorities implemented a comprehensive customs reform in September 2001.** The top tariff rate was reduced from 200 percent to 25 percent and the number of bands from 12 to 3, while the average import tariff rate declined from 18.5 percent to 9 percent. As a result, the trade restrictiveness index dropped from a rating of 6 to 4 (on a 10-point scale, with 1 being the least restrictive).

13. **In other structural reform areas, the government seems to have further increased state control over the economy** following the adoption of three proclamations: (i) the business information register, which requires yearly registration of companies and submission of their business plans for government approval; (ii) the Proclamation on Unfair Trade Practices, which allows the government to impose price controls on selected goods; and (iii) an amendment to the business licensing system, which further tightens licensing conditions. These proclamations have created considerable uncertainty, entail an excessive administrative burden, and are viewed by the business community as an additional obstacle to private sector investment and growth.

III. Report on the Discussions

A. Sources of Growth and Structural Reform

14. **Eritrea is confronted with a wide range of serious economic challenges, including crisis management and macroeconomic stabilization in the near term and moving toward a peacetime economy in support of growth and poverty reduction over the medium term.** The most critical immediate challenge is the management of the worst drought since the country's independence (see Box 1). Despite shortages in skilled manpower, the authorities are working hard to address these challenges. In this environment, the consultation discussions focused on macroeconomic policies as well as strategic policy issues such as sources of growth and the role of government.

15. **The establishment of a peacetime economy requires, above all, an acceleration of the demobilization program for combatants and their effective reintegration into civil society** (Box 4). It also requires a reassessment of the role of government in the economy and the adoption of policies aimed at promoting private sector development in support of broad-based growth, employment generation, and poverty reduction.[13] In making the transition to

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[12] No continuous data series exists on the parallel market rate.

[13] Eritrea is one of the poorest countries in the world and poverty is widespread, especially in the rural areas. A basic analysis of poverty will be possible on the basis of the recently concluded household income and expenditure survey. A full poverty survey will be part of the preparation of an interim-poverty reduction strategy paper (I-PRSP).

Box 4. Demobilization Program

Following the peace treaty with Ethiopia that ended the border conflict in 2000, a National Commission for the Demobilization and Re-Integration Programme (NCDRP) was established, and proposals were formulated for the phased release into civilian society of some 200,000 combatants. At that time, about 270,000 regular soldiers and combatants were enlisted in the military, the equivalent of about 6½ percent of the total population. By the end of 2002, 5,000 combatants had been discharged as part of a pilot program. During the consultation discussions, the authorities indicated their intentions to demobilize in a three-phase process. The first phase would involve the demobilization of some 70,000 combatants, by end-January 2003, mostly women, people with scarce skills and family needs, and sick people, and the second phase would include a further demobilization of 60,000 combatants by end-July. Given remaining uncertainties about financing, the authorities have not yet determined the dates of the third phase, during which the remaining 70,000 combatants are to be demobilized.

Achieving a smooth reintegration of large numbers of combatants poses considerable social, economic, and political challenges. In particular, successful economic reintegration requires retraining to restore lost skills and the adaptation to a new economic environment comparable to the premobilization situation. Also, as the NCDRP's survey shows not only a few combatants own any assets other than land/livestock, and that most of them would require a means to survive until a source of income is found. Furthermore, a sudden inflow into society of a large number of combatants creates the risk of social unrest, particularly in light of the army's function as a social safety net that provides a minimum income. To address these risks, the authorities' demobilization plan involves a social reintegration component, including counseling and medical rehabilitation, and an economic reintegration component, including training and technical assistance in preparing business plans. Reinsertion is also facilitated by monthly payments of, on average, about ERN 550 for 6 to 12 months as a Transitional Safety Net (TSN). As a consensus-building exercise, the order in which combatants are to be demobilized has been determined through a survey among mobilized soldiers carried out by a committee consisting of government representatives and the Chamber of Commerce.

The scope of the measures that are required to ensure a smooth demobilization and reintegration process gives rise to significant financing needs. The cost of the program is estimated at US$197 million. The World Bank has taken the lead on the program and serves as a trustee for donor funding. About US$124 million has so far been committed by the international donor community, including the World Bank (€ 60 million), the Netherlands (US$12 million) and the EU (€47 million). Although this leaves part of the third phase unfunded, the authorities are confident that additional financing will be forthcoming upon implementation of the first two phases.

While the costs of demobilization are significant, the economic costs of maintaining a large military force are likely to be far higher and extend beyond direct costs, such as soldiers' wages and support for their families. A survey by the NCDRP has shown that most Eritrean combatants are fairly young and literate, with skills and premobilization work experience. Given a labor force of roughly 2 million persons in 1999, any delay in demobilization would keep a large and skilled population, equal to about 10 percent of the potential labor force, from freely engaging in productive economic activities. Labor shortages have been an important constraint that has adversely affected agricultural production, as well as firms in the industrial and service sectors and public administration.

In addition to the above-mentioned complexities, technical difficulties such as insufficient data on the combatants to be demobilized have slowed progress in the demobilization process. As a consequence, only 20,000 combatants had been demobilized by end-February. A recent mission by the World Bank, nevertheless, rated the authorities' progress as satisfactory, given the difficulties. Further progress toward a swift and complete implementation of the demobilization program would significantly boost economic activity and reduce the fiscal deficit. It would also improve the foreign reserves position of the country, at least in the first round, when donor funds to finance demobilization are disbursed.

a peacetime economy, it will be important to rely on a participatory process for defining policy priorities, so as to ensure a broad sharing of responsibility between government and the private sector, as well as greater transparency and predictability of government policies.

16. **Given the country's limited natural resources and arable land, the labor force is Eritrea's most promising source of growth.** The staff argued that rapid implementation of the demobilization program would be needed to relieve the widespread shortages of skilled labor in the private and public sectors and, more specifically, to augment the workforce in agricultural production. To raise labor productivity and competitiveness, there is a pressing need to provide extension services, distribute improved seeds and other inputs in the agricultural sector, and to promote human capital development. The authorities noted that investments in the education and health sectors were being increased, and that considerable resources were being spent under the demobilization and national service programs to provide combatants and civilians with useful skills formation. The staff welcomed these measures but felt that care had to be taken to avoid preempting employment decision in individuals or favoring public sector needs over the private sector demand for labor.

17. **The authorities confirmed their commitment to strengthen the role of the private sector, but they believed that the sector was not yet ready to take the lead in a number of critical areas.** As a result, they feel that the government needs to play an important part in supporting the development of the productive sectors, and that it cannot limit itself to the traditional focus on investment in economic and social infrastructure. At the same time, the authorities reiterated that the government did not intend to remain permanently involved in activities that would normally fall within the scope of the private sector. Currently, in an effort to diversify the economy and exports, the authorities are seeking to exploit the economic potential in the eastern lowlands bordering the Red Sea, where significant scope is seen for fishing, fresh flowers, and vegetables for foreign markets; where possible, activities are being started as joint ventures with foreign investors. They also noted that Eritrea's trade regime was among the most liberal in Africa.

18. **While welcoming these efforts to promote growth, staff stressed the importance of establishing an appropriate framework of conditions and incentives to encourage private sector development, while limiting government activities to the production of public goods.** The staff cautioned the authorities to avoid establishing dominant publicly owned or managed enterprises that could give rise to economic inefficiencies, distort competition, and hamper market entry. The staff also expressed concerns about some aspects of the recently issued proclamations governing the activities of private enterprises, because they could adversely affect domestic and foreign investment and undermine the development of the private sector. For their part, the authorities noted that since 1993, thirty-seven government enterprises had been privatized under international bidding processes. They also explained that the Proclamation on Unfair Trade Practices, which allowed the government to impose price controls, sought to prevent excessive profit taking during periods of shortages. While sharing the authorities' concern about the social implications of high prices for food staples, the staff advised that competition be promoted to prevent excess profit taking. The staff also stressed the need to review the tighter business licensing conditions and the new procedure of requiring government approval of business plans, in order to prevent that these

regulations impeded the establishment of new businesses, and private sector development in general.

19. **There is substantial scope for improving the functioning of the economy and public administration by increasing transparency and the availability of information and strengthening dialogue.** Only very limited information on economic policies and developments is made available on a regular basis both within and outside the administration. The staff urged the authorities to substantially increase transparency, including notably fiscal transparency, and publish budget documents as a matter of course. In addition, it called for a broad and active consultation process with civil society in connection with the preparation of a poverty reduction strategy paper that could serve as a basis for a Fund-supported program under the Poverty Reduction and Growth Facility (PRGF). The staff also recommended the publication of the staff report on the 2003 Article IV consultation.

20. **The poor state of statistics severely undermines the authorities' capacity to design and implement sound policies and impairs the ability of the private sector to make informed decisions.** In this regard, the authorities pointed to manpower problems and noted that organizational issues would be addressed under a Statistical Act that was being finalized and envisages the establishment of statistical structures and processes in line with best international practices. The staff urged the swift promulgation of the act and called for the provision of adequate financial and human resources for its effective implementation.

B. Macroeconomic Policies

21. **The authorities stated that they were well aware of the seriousness of the macroeconomic imbalances facing the country, and that they had no fundamental disagreement with the recommendations made by the staff.** They regard 2003 as a year of transition, during which they intend to provide clear signals about their commitment to macroeconomic stability and lay the foundations for a more normal conduct of macroeconomic and development policies.

Fiscal policy

22. **The authorities agreed that the fiscal deficits observed over the past four years were not sustainable.** They explained that the border conflict and the need to rehabilitate economic and social infrastructure had been important factors behind the recent fiscal developments. In addition, they pointed out that significant investments in human capital were being made to strengthen the country's competitiveness and its capacity to absorb new technologies. While recognizing these expenditure needs, the staff urged the authorities to reduce the fiscal deficit to more manageable levels, given the existing high ratios of domestic and external public debt to GDP,[14] as well as the high ratio of NPV of external public debt to exports of goods and services. In the latter context, the staff urged the authorities to rely on grants and concessional loans for development financing.

[14] Domestic debt of government is held in almost equal shares by the central bank and commercial banks. About 60 percent of external debt is multilateral debt. The main bilateral creditors are Kuwait and Saudi Arabia.

23. **The authorities explained that the draft 2003 budget was an "austerity budget" intended to address concerns about fiscal sustainability.** Under this budget, current expenditure is to be reduced from levels close to 40 percent of GDP in 2001 and 2002 (and more than 50 percent of GDP during 1998–2000) to 22 percent of GDP in 2003. Defense spending is to be cut by half, owing to the planned implementation of the demobilization program, which envisages the release of some 130,000 combatants in 2003.[15] At the same time, the budget foresees a large increase in foreign-financed capital spending for which funding is ensured. On the revenue side, the main factors are the planned sale of government-owned houses and apartments (ERN 700 million) and the privatization of three government-owned hotels (ERN 135 million). Together, these two items are expected to yield revenues equivalent to 7 ½ percent of GDP in 2003. Tax revenue proper is projected to decline slightly because of the effects of the 2001 reduction in the average corporate tax rate from 34 percent to a flat rate of 30 percent. Based on these assumptions, the domestic deficit is projected to drop from about 21 percent of GDP in 2002 to 6½ percent of GDP in 2003, while the overall deficit, including grants, would be reduced from 30 percent of GDP in 2002 to about 24 percent of GDP in 2003.

24. **The staff welcomed the authorities' determination to substantially reduce the fiscal deficit in 2003.** At the same time, however, the staff explained that some of the assumptions underlying the draft budget might be too optimistic. In particular, the sale of houses and apartments and the privatization of hotels might prove to be more difficult and time-consuming than assumed. Similarly, the demobilization process involves complex administrative and social challenges that may delay the achievement of the related budgetary objectives. The staff, therefore, suggested that it would be prudent to adopt more conservative revenue and expenditure projections, in order to forestall the call for higher spending during the budget approval process. At the same time, it urged the authorities to aim at reducing the domestic deficit to about 10 percent of GDP in 2003.

Monetary and financial sector policies

25. **Monetary policy has been entirely subordinated to the financing needs of government, despite a central banking law that gives the BE significant independence.**[16] An autonomous monetary policy became possible with the introduction of a domestic currency, but the border conflict with Ethiopia that followed shortly thereafter did not give much room to the BE to pursue its main statutory objectives, notably to "safeguard the value of the national currency." Instead, the net claims of the BE on the government increased strongly, exceeding 80 percent of the bank's net domestic assets since 1999. These developments have led to rising inflation and growing current account deficits and foreign reserve losses. The staff, therefore, underscored the importance of reducing the fiscal deficit and curtailing its bank financing. The staff also regretted the decision to lower the required reserves ratio and called for tighter monetary conditions. In addition, to avoid significant distortions in financial intermediation, the staff stressed that interest rates on at least bank

[15] For more details on the demobilization program, see Box 4.

[16] For a detailed discussion of monetary policy and management, see the accompanying selected issues and statistical appendix.

lending needed to be restored to positive levels.[17] For better monetary management, the BE needs to urgently develop a coherent and transparent monetary policy framework and a clear strategy for the rational use of its policy instruments, with well-defined objectives.[18] The authorities broadly agreed with these recommendations, but noted that progress in these areas would depend on effective institution and capacity building, for which they would seek technical assistance from the Fund.

26. **The conduct of an effective monetary policy is also hampered by the structure of the financial sector.** The concentration of financial activities, at times with a narrow ownership base, and the presence of the dominant state-owned CBE severely weaken competition, undermine the application of commercial criteria in banking decisions, and reduce the effectiveness of the transmission of monetary policy measures. The staff, therefore, advocated measures to achieve more competition in the financial sector, including through the breaking up of the CBE into smaller units and their privatization. The authorities indicated that privatization was not currently on their agenda, but that they would welcome the entry of new banks, including fully foreign-owned banks.

27. **The BE has made good progress in establishing a credible supervision framework based on international standards and practices.** However, the implementation of this framework needs to be strengthened to enforce banks' compliance with key prudential ratios, increase the transparency and accountability of their operations, and ensure the adoption of international accounting practices. The staff noted the deterioration in banks' lending portfolio as a result of the border conflict and unsound lending decisions, and urged the full implementation of the BE's corrective action plan in order to forestall a financial crisis. It also welcomed the recapitalization of the CBE and HCBE to statutory levels, but called for more comprehensive corrective actions for these banks, following full-scale on-site inspections and planned external audits.[19] The authorities reported that the principal elements for the anti-money laundering and combating the financing of terrorism (AML/CFT) program were in place.[20]

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[17] Banks are in principle free to set interest rates. However, they appear to follow "informal" guidelines. For deposit rates, the large diaspora transfers and related excess reserves are unlikely to lead to positive real deposit rates under full commercial practices and market conditions.

[18] These issues are discussed in more detail in the accompanying selected issues paper on monetary policy and management.

[19] Implementation of recommendations of the action plan will be assisted by the MAE Advisor in Banking Supervision whose contract has just been renewed for another year.

[20] Actions taken by the authorities include (i) the criminalization of money laundering and terrorism financing; (ii) the confiscation of proceeds of crime or property used to finance terrorism; (iii) the setting up of reporting requirements for suspicious transactions; and (iv) the establishment of a Financial Intelligence Unit (FIU). Additional preventive measures, including the establishment of specific guidelines, are under preparation.

Exchange rate regime

28. **The most distorting and detrimental effects for the economy emanate from the current dual exchange rate regime, which has existed since 1998.**[21] The current rate differential of some 60 percent between the official and parallel rates constitutes a multiple currency practice subject to Article VIII, Section 3 of the Articles of Agreement, and the exclusion of the majority of bona fide payments for current international transactions from access to foreign exchange at the official rate gives rise to exchange restrictions subject to Fund approval under Article VIII, Section 2(a). The shortages of official reserves are such that, at times, some government transactions have to be satisfied in the parallel market. From a macroeconomic perspective, the current exchange rate regime undermines the efficiency of resource allocation not only because it generates a "public/private divide" in the access to foreign exchange, but also because it sharply increases information and transactions costs for the private sector. At the microeconomic level, the regime, like any rationing system, encourages rent seeking and fraud. However, perhaps the most important problem with the present system is that it erodes trust and confidence in the government by encouraging private agents to adopt a mode of operation that is illegal.

29. **Although the authorities shared the above concerns, they stated that the current exchange system was likely to be retained until the foreign reserves situation had eased.** Thereafter, their preferred exchange rate regime would be a managed float. As regards competitiveness and the costs to the private sector, they noted that private transactions were largely taking place at the parallel market rate and believed that the sluggish export growth was a broader problem of supply-side constraints rather than a competitiveness issue.

30. **The staff emphasized that a reform of the exchange system was urgently needed to eliminate its restrictive and distortionary features.** For this purpose, a flexible market-based mechanism would need to be established for adjusting the official exchange rate to market levels and achieving an eventual unification of foreign exchange markets. It would also be important to support the unification of the rates by a phased removal of exchange restrictions on current transactions. The mission recommended that the authorities make an urgent request for technical assistance from the Fund to develop the operational modalities for introducing such a unified and flexible exchange rate regime.

IV. Economic Outlook

31. **The preparation of a medium-term macroeconomic outlook was beset by a number of difficulties, including, in particular, the lack of timely and reliable data.** Also it remains unclear whether the political governance issues on which balance of payments and budgetary support hinge can be resolved satisfactorily in the near future. Given the limited immediate capacity for expanding exports, such assistance will be critical for easing the tight foreign exchange constraint that currently hampers investment and activity in virtually all

[21] For an in-depth description and evaluation of the exchange rate regime in Eritrea, see the companion selected issues and statistical appendix.

sectors of the economy. Nevertheless, the staff prepared two medium-term scenarios, including a basic debt sustainability assessment (Box 5).

32. **The baseline scenario assumes that the current tight labor shortages and foreign reserves constraints will continue for some time, mainly because of delays in the demobilization of combatants and lack of adequate inflows of external assistance.** The latter projection is based on the assumption that the political governance issues raised by donors regarding the formation of parties and free elections will take some time to be resolved in a satisfactory way and, as a result, donor financing will essentially remain limited to humanitarian assistance. In this situation, economic growth would be severely constrained because private sector activity would face binding labor and foreign exchange constraints. In addition, inflation will remain high because of (i) supply-side constraints; (ii) excess demand caused by strong money and credit growth to compensate for the lack of foreign financing; and (iii) a continued depreciation of the currency. The domestic fiscal deficit will remain largely unchanged, at a level exceeding 14 percent of GDP for most of the projection period, while the overall fiscal deficit (including special programs and grants) will decline as donor-financed investment projects are reduced. In addition, shortages of foreign exchange will limit imports of intermediate and investment goods for private sector production and thereby cause a forced increase in private sector savings, which, in turn, will reduce the external current account deficit.

33. **The economic outlook for 2003 in the above baseline scenario is particularly disappointing.** Private sector activity and GDP growth are expected to increase by a considerably lower rate than would have been possible with full implementation of the demobilization program and the accompanying increase in foreign exchange. GDP growth is therefore projected at 5 ½ percent against the 10 ¼ percent considered possible otherwise. The slower growth in domestic production and the tighter foreign exchange situation are expected to prevent a more rapid decline in inflation following the drought. Reflecting higher spending and lower revenue growth, the domestic fiscal deficit is projected to amount to 13 ½ percent of GDP, compared with a targeted budget deficit of 6 ¼ percent of GDP. The larger financing needs of government are expected to be met primarily from domestic sources. This will not only curtail the scope for expanding private sector credit, but also further curtail foreign exchange allocation to the private sector. The depressed economic conditions and the external financing constraints are likely to be accompanied by a shrinkage of both foreign trade, mainly imports, and the external current account deficit.

34. **With the assumed decline in external financing over the medium term, the government's access to domestic financing will be higher.** As a result, public sector domestic debt will increase further, reaching 131 percent of GDP in 2008. At the same time, in line with the drawdown of existing loan commitments, the level of external debt as a percent of GDP will rise over the period 2003-05 to almost 90 percent of GDP, but decline thereafter, to about 85 percent of GDP by 2008. The NPV of both external debt and external debt service, as a percent of exports of goods and services, will also increase initially and then begin to drop by the end of the projection period.

Box 5. Medium Term Scenarios

	2002 Est.	2003	2004	2005 Proj.	2006	2007	2008
Baseline:							
	(Annual percentage changes)						
Real GDP (at factor prices)	-1.2	5.4	9.0	5.1	3.8	3.8	3.8
Consumer prices (annual average)	16.9	18.8	12.4	10.5	9.5	9.0	9.0
	(In percent of GDP)						
Domestic balance 1/	-20.8	-13.6	-12.0	-15.0	-15.5	-15.3	-15.0
Overall fiscal deficit 2/	-30.1	-24.4	-25.6	-23.7	-22.4	-20.9	-20.3
External current account 3/	-15.4	-10.4	-13.3	-8.4	-6.3	-5.2	-5.3
Domestic debt	123.2	116.6	112.4	117.7	123.3	128.3	131.3
External debt	78.6	76.4	84.5	89.3	88.4	86.6	84.8
	(In percent of exports of goods and services)						
NPV of External debt	198.3	180.1	185.3	213.5	236.5	260.5	254.8
External debt service	15.1	12.9	10.8	16.4	15.0	15.0	13.7
	(In percent of domestic revenues)						
External debt service	8.2	14.1	12.3	15.0	14.0	14.1	11.8
Alternative:							
	(Annual percentage changes)						
Real GDP (at factor prices)	-1.2	10.3	9.5	8.0	6.0	6.0	6.0
Consumer prices (annual average)	16.9	16.1	8.0	6.5	5.5	5.0	5.0
	(In percent of GDP)						
Domestic balance 1/	-20.8	-11.9	-11.5	-11.2	-9.1	-7.5	-5.5
Overall fiscal deficit 2/	-30.1	-24.2	-18.8	-17.3	-11.8	-9.4	-8.1
External current account 3/	-15.4	-13.6	-12.9	-10.8	-7.1	-4.6	-4.1
Domestic debt	123.2	109.0	104.4	102.6	100.6	98.4	95.6
External debt	78.6	77.7	83.4	89.6	87.8	83.8	79.2
	(In percent of exports of goods and services)						
NPV of External debt	198.3	185.0	191.2	221.5	239.8	237.2	221.3
External debt service	15.1	12.3	11.7	14.3	12.6	12.1	10.7
	(In percent of domestic revenues)						
External debt service	8.2	13.4	12.1	14.1	12.9	12.8	10.6

Source: Eritrean authorities; and staff estimates and projections

1/ Total revenue less expenditures excluding, external interest, humanitarian assistance, reconstruction, demobilization, and other externally financed outlays.
2/ Including special programs and grants
3/ Including official transfers.

35. **Under the alternative scenario, a swift and full implementation of the demobilization program is assumed.** As a result, 130,000 combatants will be released by end-2003, and the residual 70,000 by end-2004. This will lead to an increase in labor supply to the productive sectors of the economy and raise donor funding for demobilization. In addition, this scenario assumes that the political governance issues are resolved in 2003 so that donors can resume their budgetary and balance of payments assistance. In these circumstances, government financing needs could be met without excessive reliance on domestic financing. This scenario also assumes that the dual exchange rates are unified, supported by appropriate reforms and restrained macroeconomic policies.

36. **Reflecting these assumptions, the growth rate rises substantially over the medium term, and by 2008 real GDP is 15 percent higher than under the baseline scenario.** At the same time, inflation is substantially reduced, reflecting a better supply response and a more stable exchange rate.[22] The combination of a stronger economy and higher donor financing will significantly strengthen the sustainability of the public finances. The domestic fiscal deficit will drop to about 5 ½ percent of GDP by 2008, compared with more than 15 percent under the baseline scenario. Over the period 2003–08, the overall fiscal deficit (including special programs and grants) will decline by about 16 percentage points to 8 percent of GDP, despite considerably higher investment than under this baseline scenario. Reflecting the large related increase in external financing, the ratio NPV of external debt to exports of goods and services will remain above 200 percent despite a decline after 2006. Nonetheless, the level of total public debt in percent of GDP will be significantly lower in 2008 than under the baseline scenario, and long-term debt sustainability will have improved because of the strengthening of economic growth and exports.

V. PROGRAM ISSUES

37. **The authorities expressed renewed interest in a Fund-supported program and proposed to take steps to move toward an arrangement under the Poverty Reduction and Growth Facility (PRGF).**[23] The authorities are aware of the preparation needed for the negotiation of such an arrangement and mentioned that they had already started preparing an interim poverty reduction strategy paper (I-PRSP), a first draft of which would be ready by mid-June 2003. They accepted that to prepare the basis for a PRGF-supported program a solid track record of policy implementation needed to be established under a staff-monitored program (SMP) and requested that a mission return to Eritrea in mid-2003 to discuss an SMP.

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[22] Because of improved financial stability and a greater inflow of foreign exchange from donors under the alternative scenario, the (unified) exchange rate will depreciate less than the parallel exchange rate under the baseline scenario.

[23] An interim move toward post-conflict emergency assistance did not appear possible because of the absence of broad donor support.

VI. Staff Appraisal

38. **Eritrea is facing enormous economic challenges in both the short and medium term.** Addressing these challenges in a way that will strengthen growth and reduce poverty will require a combination of decisive crisis management, sound macroeconomic and development policies, and extensive donor support. Along with urgent actions to address the problems of the drought, a strong and determined effort needs to be launched soon to effectively address the country's large macroeconomic imbalances, in order to restore economic stability and boost investor confidence. Decisive implementation of policies to address these issues is also critical for renewed donor assistance. The authorities are well aware of these challenges and are working hard to master them. They are preparing a poverty reduction strategy paper and a new medium-term economic strategy for the period 2003–06, which could eventually serve as a basis for an arrangement under the Fund's PRGF. Efforts are also under way to formulate a comprehensive food security strategy and implement the agriculture and rural development plan. The staff welcomes these important initiatives and urges the authorities to ensure their successful implementation.

39. **Given the seriousness of the drought and the continued significant dislocation of the population, the authorities' attention is appropriately focused on crisis management.** In this context, it would be critically important to progress rapidly with the demobilization of combatants, so as to alleviate the labor shortage in agriculture as well as other sectors. At the same time, there is a need to regain the prewar focus on development issues and policies, with a view to achieving high growth rates and a steady and sustainable reduction in poverty.

40. **A successful move toward a peacetime economy will also require a reassessment of the role of government and the adoption of policies that could promote the development of the private sector.** In this regard, there is a need to avoid the dominance of publicly owned or managed enterprises, which could distort competition, hamper market entry, and give rise to new inefficiencies. Similar restraint should be exercised to avoid enacting regulations that could create uncertainty for enterprises, entail an excessive administrative burden, and cast doubts on the authorities' professed commitment to private sector development. In particular, the recent official proclamations, which tighten business licensing procedures and require the submission of business plans, should be reviewed to avoid implementing regulations that could seriously impede the expansion of the private sector.

41. **Macroeconomic developments in 2002 are a source of considerable concern, and the outlook for 2003 and beyond is subject to much uncertainty.** While growth may recover somewhat in 2003, inflation is likely to remain high. The lack of donor financing would lead to a continuation of balance of payments pressures and hamper growth and development because of continued shortages of foreign exchange. It will, therefore, be important to reach agreement with the donor community on the governance issues that have so far prevented its full reengagement in the financing of development in the country.

42. **The draft budget for 2003, which aims to achieve progress toward fiscal and external sustainability, is welcome.** The authorities should retain the broad objective of substantially reducing the fiscal deficit and firmly implement the policy measures provided under the budget to reduce the domestic deficit to about 10 percent of GDP in 2003. The

intended shift in budgetary spending from defense to education and health is welcome. Efforts should also be made to further strengthen and streamline expenditure control and monitoring, as well as improve revenue administration and collection. In particular, the tax administration and income tax laws should be passed to give legal backing to needed actions.

43. **Monetary policy and management need to be conducted in a manner that is consistent with the Bank of Eritrea Proclamation.** The BE needs to become an independent partner in the formulation and implementation of the country's economic and financial policies. At the same time, monetary policy should be closely coordinated with fiscal policy, including, notably, with respect to the domestic financing of the budget. Monetary tightening, including a move toward positive real interest rates, needs to be supported by fiscal restraint to achieve the domestic inflation and external balance objectives. In addition, the BE should develop an adequate monetary policy framework to achieve its objectives of safeguarding the domestic and external value of the national currency. Such a monetary policy framework would need to provide a nominal anchor for the conduct of monetary policy and be consistent with the exchange rate regime to be put in place. In this context, the authorities could benefit from technical assistance from the Fund.

44. **Improvements in monetary policy and management will need to be buttressed by a strengthening of prudential regulation and supervision.** The problems of financial institutions need to be addressed urgently by taking the steps needed to achieve a durable strengthening of bank management and operations, and to ensure the adoption of international best practices. In particular, full on-site inspections of banks would be highly desirable and should be undertaken in the near future. Should these reveal significant risks to stability and threats to solvency, an action plan should be developed with the help of the Fund's resident advisor and implemented with urgency.

45. **It will be also important to address the absence of true competition in the financial sector because it severely undermines the efficiency of financial intermediation and private sector development.** To that end, foreign banks or partnerships should be attracted, and the breaking up and privatization of the dominant financial institutions in commercial banking and foreign exchange markets should be considered.

46. **A reform of the present dual exchange rate regime is urgently required to eliminate resulting restrictions and distortions.** For this purpose, the authorities should consider a flexible market-based mechanism for adjusting the official exchange rate to market levels and achieving the unification of the two existing foreign exchange markets. It would be important to support the unification of the rates by a phased removal of the existing exchange restrictions on current transactions, and to eliminate its restrictive and distortionary features. The authorities should seek Fund technical assistance in developing such a reform strategy.

47. **Given the country's limited natural resources and arable land, the labor force is Eritrea's most promising source of growth.** The implementation of the demobilization program for combatants needs to be accompanied by broader efforts to invest in people and develop human capital. The authorities' focus on investment in human resources through increases in spending on education and health is welcome, as are their efforts to enhance skills through vocational training in connection with the demobilization and National Service

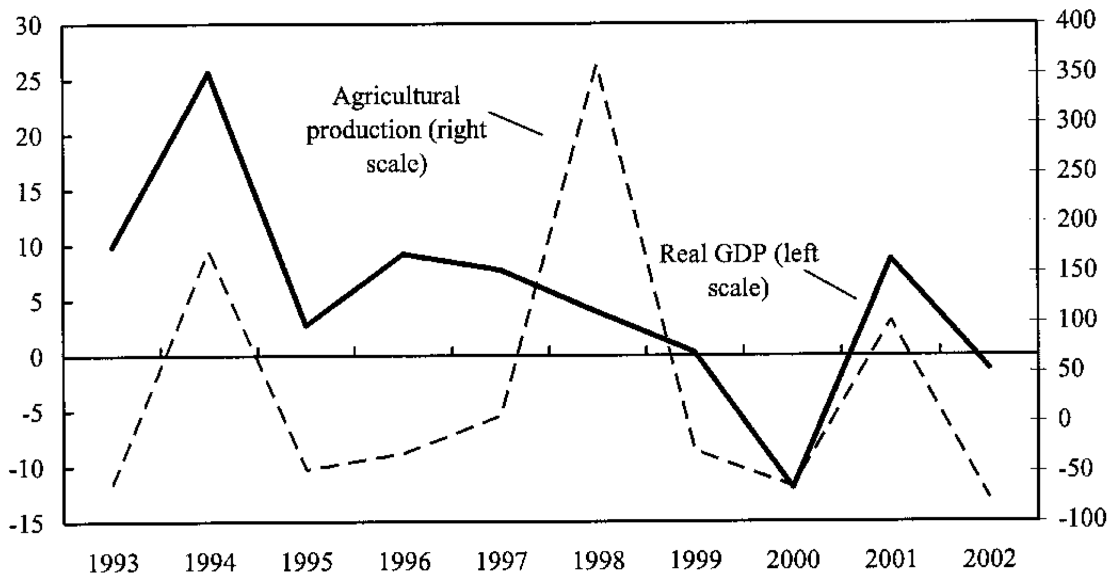
programs. However, these efforts need to focus on the availability and quality of education and training, without preempting or restricting later employment decisions.

48. **There is substantial scope for improving the functioning of the economy by broadening the flow of information, increasing transparency, and strengthening dialogue and cooperation mechanisms.** Of particular importance are greater fiscal transparency and accountability; an open debate and regular publication of the budget are therefore indispensable. Similarly, the establishment of effective dialogue and cooperation within the government, and between the government and the private sector will be critical for a participatory policy process. Urgent attention will also need to be given to the establishment and regular publication of timely and reliable key statistics. The authorities should, therefore, expedite the promulgation of the draft Statistical Act and develop a strong and coherent reform agenda for the establishment of effective statistical institutions and processes, supported by adequate financial and human resources. The objective should be to compile, in the course of 2003, a solid body of core statistics and make it possible to establish a satisfactory country page for Eritrea in the IMF's *International Financial Statistics*.

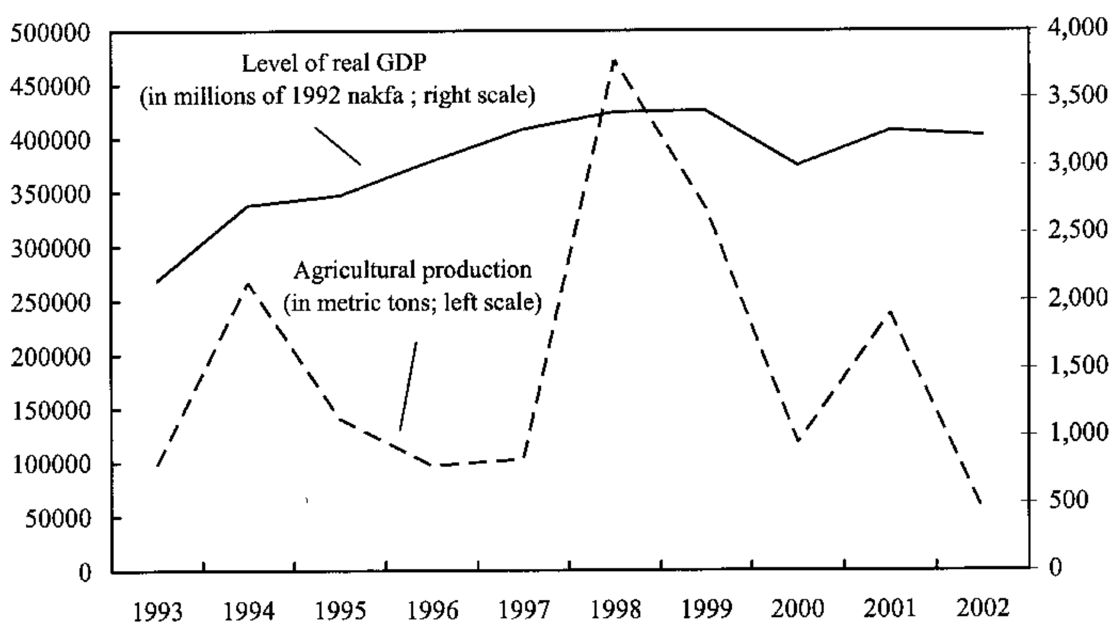
49. It is recommended that the next Article IV consultation with Eritrea be held on the standard 12-month cycle.

Figure 1. Eritrea: GDP and Agricultural Production, 1993-2002

Growth of Real GDP and Agricultural Production
(Changes in percent)



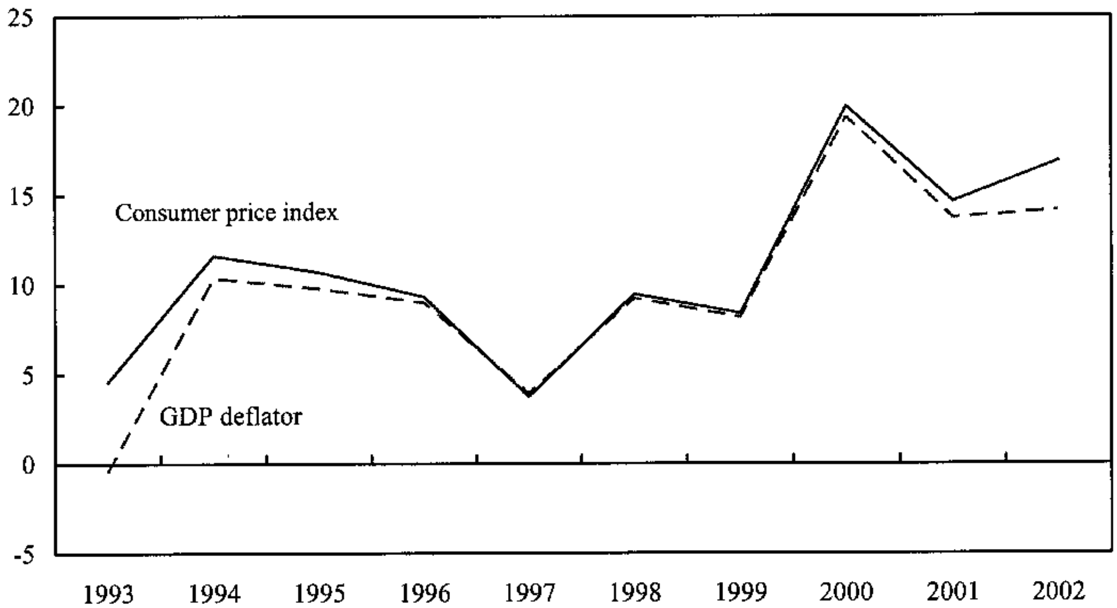
Levels of Real GDP and Agricultural Production



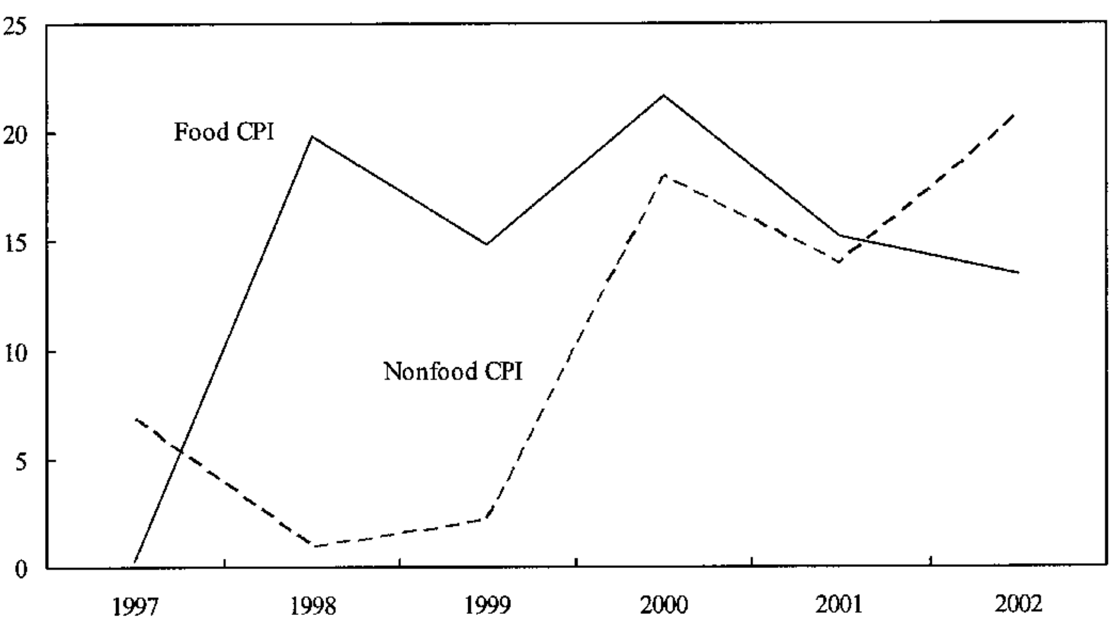
Sources: Eritrean authorities; and staff estimates.

Figure 2. Eritrea: Inflation
(Annual average percentage changes)

Consumer Prices and GDP Deflator, 1993-2002



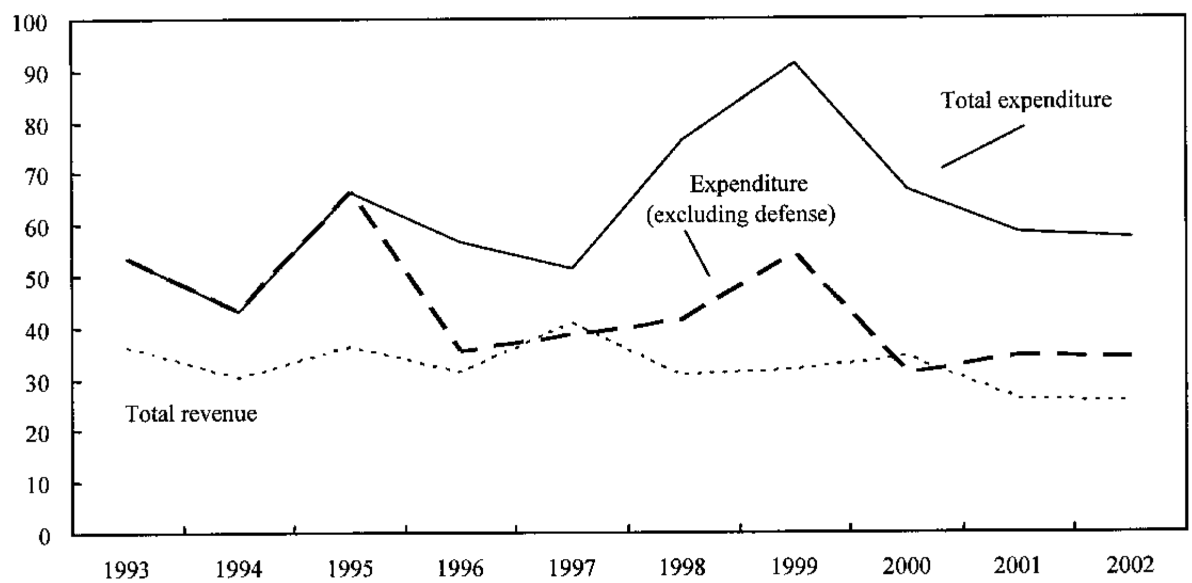
Food and Nonfood Price Inflation, 1997-2002



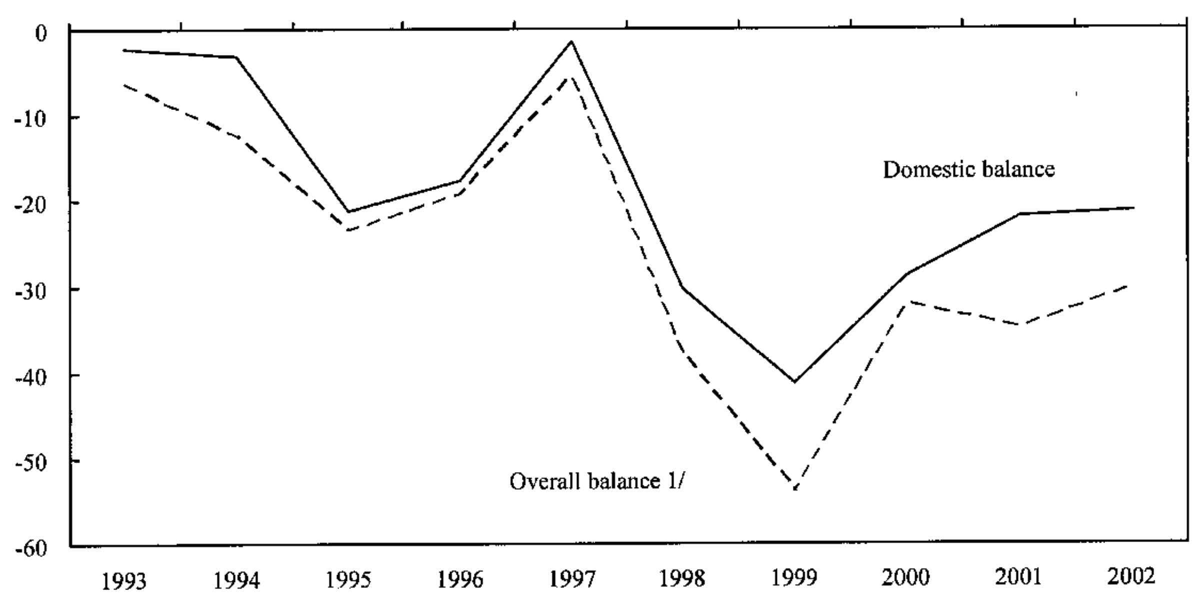
Sources: Eritrean authorities; and staff estimates

Figure 3. Eritrea: Fiscal Indicators, 1993-2002
(In percent of GDP)

Government Revenue and Expenditure

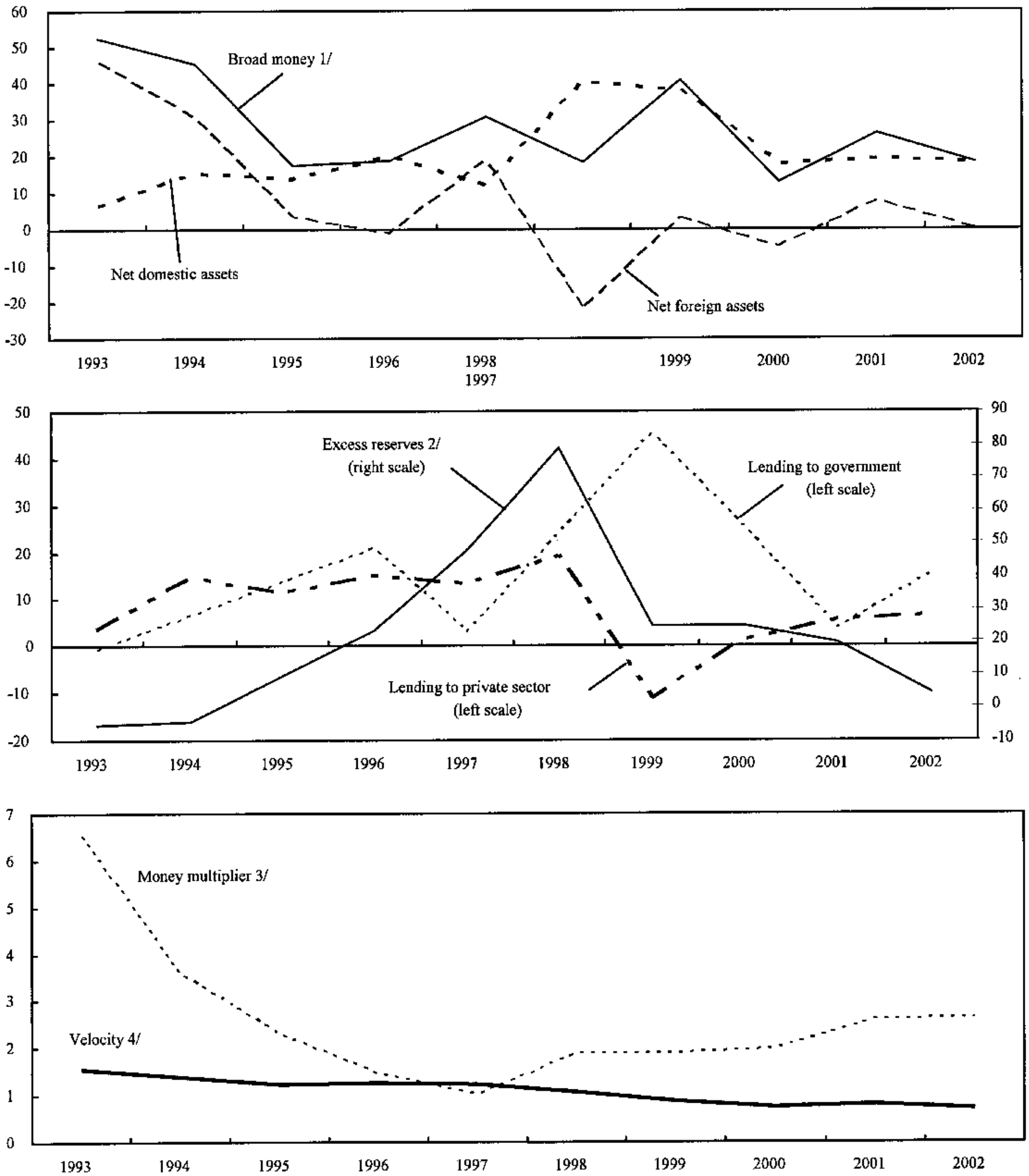


Domestic and Overall Fiscal Balance



Sources: Eritrean authorities; and staff estimates
1/ Including grants and special programs.

Figure 4. Eritrea: Monetary Indicators, 1993-2002
(In percent of broad money at the beginning of the period, unless otherwise indicated)



Sources: Eritrean authorities; and staff estimates.

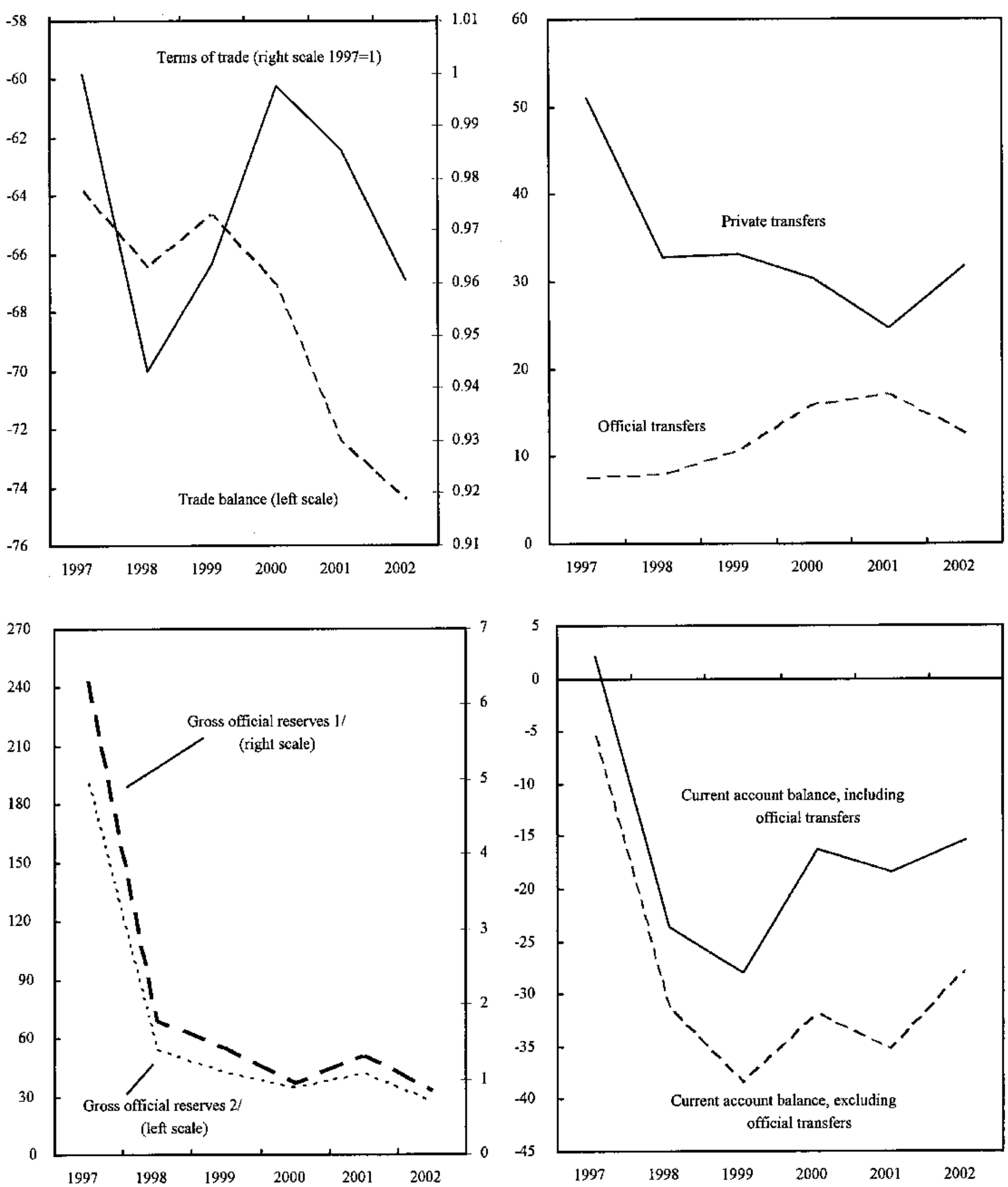
1/ Annual percentage change.

2/ In percent of deposits.

3/ (M3/base money)

4/ (GDP/average broad money)

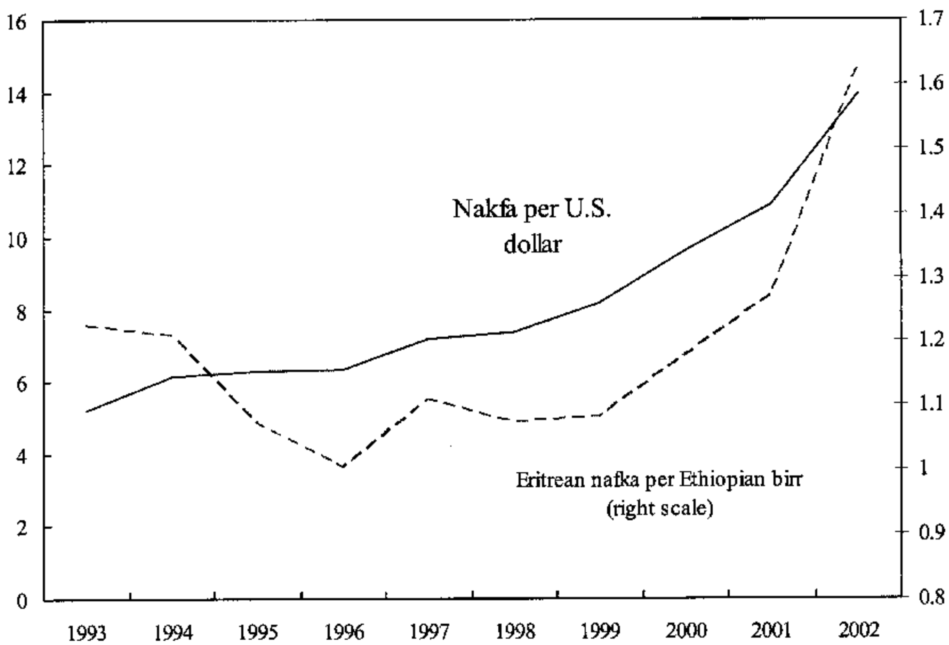
Figure 5. Eritrea: Balance of Payments Indicators, 1997-2002
(In percent of GDP, unless otherwise indicated)

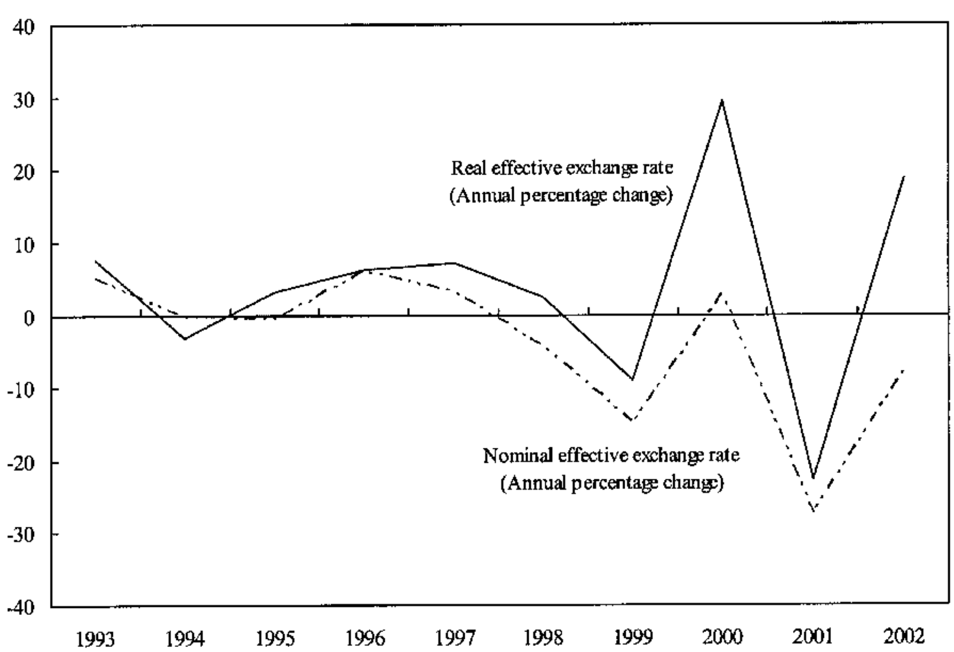


Sources: Eritrean authorities; and staff estimates.
1/ In months of imports of goods and services.
2/ In millions of U.S. dollars.

Figure 6. Eritrea: Exchanges Rates, 1993-2002

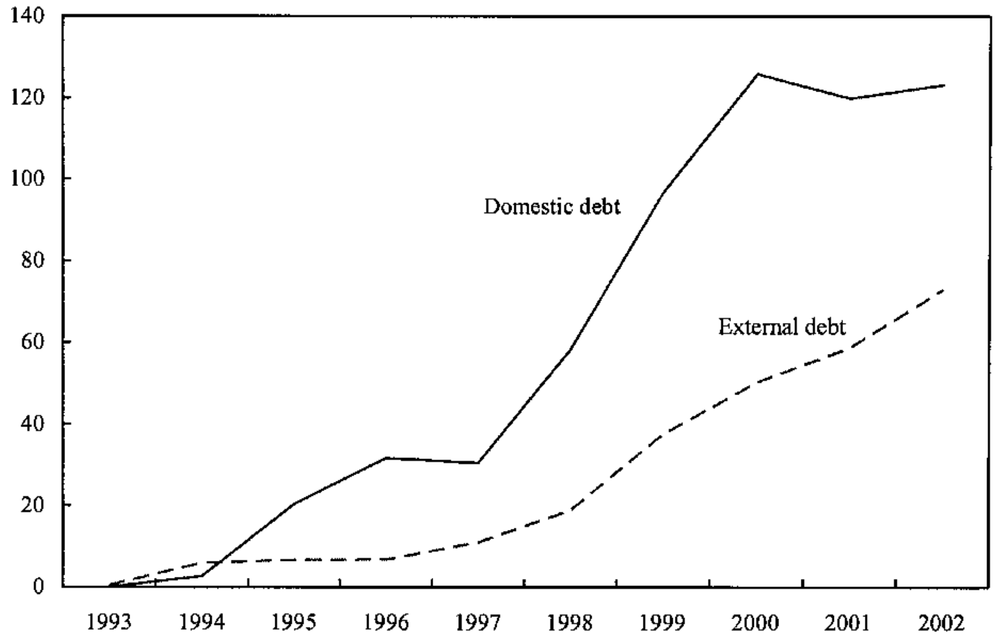
(Period average)

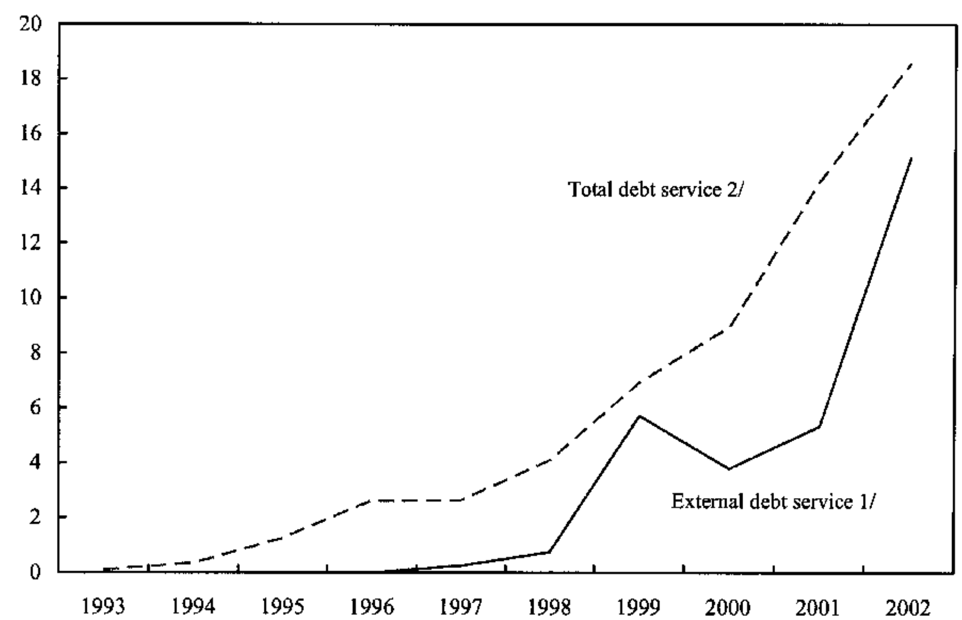




Sources: Eritrean authorities; and staff estimates.

Figure 7. Eritrea: Debt and Debt Service, 1993-2002
(In percent of GDP, unless otherwise indicated)





Sources: Eritrean authorities; and staff estimates.
1/ In percent of exports of goods and services.
2/ In percent of government revenue.

Table 1. Eritrea: Selected Economic and Financial Indicators, 1996-2003

	1996	1997	1998	1999	2000	2001 Prel.	2002 Prel.	2003 Proj.
	(Annual percentage change, unless otherwise specified)							
National income and prices								
GDP at constant factor prices	9.2	7.7	3.9	0.3	-12.0	8.7	-1.2	5.4
Nominal GDP at market prices (in millions of nakfa)	4,436.4	4,974	5,530	5,982	6,201	7,771	9,031	11,154
GDP deflator	9.0	3.9	9.2	8.2	19.3	13.7	14.1	18.0
Consumer price index (CPI) (Asmara; annual average)	9.3	3.7	9.5	8.4	19.9	14.6	16.9	18.8
CPI (Asmara; end of period)	3.4	7.7	9.0	10.6	26.8	7.7	23.8	14.0
Food CPI (end of period)	...	7.9	20.3	12.9	31.5	5.2	17.9	14.0
Nonfood CPI (end of period)	...	7.6	-0.7	8.2	21.8	10.7	30.4	14.0
External trade								
Exports, f.o.b. (in U.S. dollars)	18.2	-43.8	-47.3	-28.6	82.6	-45.7	159.6	-32.0
Imports, c.i.f. (in U.S. dollars)	27.2	-3.7	6.5	-6.1	-4.9	14.1	-0.6	7.7
Real effective exchange rate (annual average)	6.2	7.2	2.4	-8.9	29.5	-22.5	19.0	...
Exchange rate (nakfa per U.S. dollar; end of period)	8.1	7.1	7.6	9.6	10.1	13.8	14.1	...
Exchange rate (nakfa per U.S. dollar; period average)	6.4	7.2	7.4	8.2	9.6	10.9	14.0	...
Money and credit (end of period)								
Net foreign assets 1/	-1.2	18.6	-22.2	2.9	-5.0	7.4	0.1	2.0
Net domestic assets 1/	19.9	12.0	40.4	38.0	18.0	19.0	18.4	24.6
Credit to the government 1/	21.0	3.0	35.6	45.1	25.0	3.7	15.2	13.9
Credit to the economy 1/	14.9	11.3	16.6	-3.1	-2.3	4.8	4.7	9.5
Broad money (including foreign currency deposits) 2/	18.7	30.6	18.2	40.9	13.0	26.4	18.5	26.6
Velocity (GDP/average broad money)	1.3	1.22	1.08	0.88	0.76	0.79	0.73	0.73
Interest rate (savings deposits; in percent)	6.0	6.0	6.0	6.0	6.0	6.0	5.0	...
Central government operations								
Total revenue	3.0	46.1	-16.5	12.2	11.2	-5.8	15.4	25.5
Total expenditure	1.9	1.8	64.9	29.6	-24.4	9.9	13.9	8.0
Current expenditure	-12.7	-15.6	96.9	15.5	4.7	-2.3	11.2	1.7
Capital expenditure and net lending	52.9	36.5	25.5	56.8	-65.7	62.9	20.9	3.6
	(In percent of GDP, unless otherwise specified)							
Central government operations								
Total revenue	31.2	40.7	30.5	31.7	34.0	25.6	25.4	25.8
Total expenditure	56.7	51.4	76.3	91.4	66.7	58.5	57.3	50.1
Of which : domestic expenditures	49.0	42.2	60.8	73.0	59.5	47.2	46.2	39.4
Of which : defense	21.1	12.7	35.0	37.2	35.8	24.2	23.3	18.1
Excluding special programs								
Overall fiscal balance (excluding grants)	-25.4	-10.8	-45.7	-59.7	-32.7	-32.9	-31.9	-24.4
Overall fiscal balance (including grants)	-14.7	-5.0	-36.4	-51.5	-13.3	-15.2	-19.6	-5.0
Including special programs								
Overall fiscal balance (excluding grants)	-30.1	-11.4	-47.4	-62.1	-51.5	-52.5	-42.5	-43.7
Overall fiscal balance (including grants)	-19.4	-5.6	-38.0	-53.9	-32.1	-34.8	-30.1	-24.4
Domestic fiscal balance 3/	-17.8	-1.5	-30.2	-41.3	-25.5	-21.6	-20.8	-13.6
Financing	18.0	8.1	37.2	53.2	32.5	32.3	30.4	24.4
External	1.2	4.1	3.7	8.7	8.6	13.5	10.2	6.9
Domestic	16.8	4.0	33.5	44.5	23.9	18.8	20.2	17.4
Errors and omissions	1.3	-2.5	0.8	0.7	-0.4	2.5	-0.2	0.0
Central government domestic debt (net)	31.7	30.5	58.2	96.7	125.9	119.9	123.2	116.6
External sector								
Current external balance (excluding official transfers)	-19.5	-5.4	-31.5	-38.4	-32.0	-35.4	-27.8	-29.3
Current external balance (including official transfers)	-7.3	2.1	-23.6	-27.9	-16.2	-18.4	-15.4	-10.4
External public debt 4/	6.7	11.0	18.8	37.5	51.4	60.8	78.6	76.4
Net present value of external public debt/exports (in percent) 5/	0.0	25.2	51.7	135.4	225.9	247.8	198.3	180.1
Debt service/exports (in percent)	0.0	0.3	0.8	5.7	3.8	5.3	15.1	12.9
National accounts								
Investment	28.0	31.9	26.6	34.1	18.5	28.5	26.3	22.4
Private	12.8	13.9	6.3	4.9	6.8	8.4	9.1	9.8
Public	15.3	18.0	20.3	29.3	11.6	20.1	17.2	12.5
Gross national savings	20.6	34.0	3.0	6.2	2.3	10.1	10.9	12.0
Private	24.7	21.6	20.7	30.9	22.8	24.8	23.9	23.8
Public	-4.1	12.4	-17.7	-24.6	-20.5	-14.7	-12.9	-11.8
Savings-Investment balance	-7.4	2.1	-23.6	-27.9	-16.2	-18.4	-15.4	-10.4
Private	11.9	7.7	14.4	26.0	15.9	16.4	14.7	14.0
Public	-19.4	-5.6	-38.0	-53.9	-32.1	-34.8	-30.1	-24.4
	(In millions of U.S. dollars, unless otherwise specified)							
Current account balance (excluding official transfers)	-48.9	-37.0	-235.9	-282.1	-206.8	-252.1	-179.9	-216.8
Overall balance of payments	53.5	146.7	-174.1	-14.7	-15.2	7.2	-39.0	1.6
Gross international reserves	126.2	243.3	69.0	54.3	36.6	50.6	33.1	30.5
(in months of imports of goods and services)	2.7	5.0	1.4	1.1	0.9	1.1	0.7	0.6

Sources: Eritrean authorities; and staff estimates and projections.

1/ Change in percent of broad money at the beginning of the period.
2/ Figure before 1997 excludes currency outside banks in Eritrea.
3/ Total revenue less expenditures, excluding external interest, humanitarian assistance, Emergency Reconstruction Program (ERP), demobilization, and other externally financed outlays.
4/ Public and publicly guaranteed debt, including projected new debt.
5/ Three-year average of exports of goods and services used.

Table 2. Eritrea: Summary of Government Operations, 1996-2003

	1996	1997	1998	1999	2000	2001	2002		2003	
						Act.	Budget	Est.	Budget	Proj.
	(In millions of nakfa)									
Total revenue and grants	1,863.5	2,310.7	2,208.1	2,384.5	3,313.1	3,361.9	6,423.6	3,409.8	6,836.8	5,037.4
Revenue	1,384.9	2,022.8	1,688.7	1,895.5	2,108.3	1,986.4	2,084.1	2,291.4	3,341.8	2,875.8
Tax revenue	830.4	959.4	977.0	1,018.7	982.7	1,278.8	1,506.1	1,538.2	1,765.3	1,766.0
Direct taxes	380.0	447.9	512.3	518.7	473.5	572.9	654.5	552.8	587.0	620.0
Indirect domestic taxes	180.7	212.8	198.5	236.8	238.1	297.0	400.0	368.3	439.9	435.0
Import duties and taxes	269.7	298.7	266.1	263.3	271.0	409.0	451.5	617.1	738.4	711.0
Nontax revenue	554.5	1,063.4	597.8	599.9	802.8	532.7	578.0	724.1	1,532.2	1,065.5
Extraordinary revenues	0.0	0.0	113.9	276.9	322.9	174.9	0.0	29.2	44.3	44.3
Grants	272.6	619.1	519.4	489.0	1,204.8	1,375.6	4,339.5	1,118.4	3,495.0	2,161.6
Private	0.0	0.0	0.0	61.2	131.4	40.4	30.0	20.1	55.7	55.7
Official	478.6	287.9	458.2	357.6	1,008.9	1,335.1	4,309.5	1,098.3	3,439.3	2,105.9
Humanitarian	170.6	194.6	32.7	90.7	142.0	866.3	1,284.8	483.4	1,233.5	1,064.0
Demobilization	0.0	0.0	0.0	0.0	0.0	6.9	0.0	6.5	0.0	590.4
Capital projects	287.2	284.0	255.2	367.5	215.6	462.0	2,664.7	608.4	2,205.8	451.5
Program	0.0	0.0	0.0	0.0	0.0	0.0	360.0	0.0	0.0	0.0
Expenditure and net lending (excluding special programs)	2,513.8	2,558.1	4,218.8	5,467.9	4,136.4	4,545.3	6,788.2	5,176.9	8,271.9	5,592.3
Current expenditure	1,674.7	1,412.8	2,781.6	3,213.9	3,364.2	3,287.3	2,902.5	3,656.0	2,705.2	3,716.8
Wages, salaries, and allowances	798.3	706.8	858.3	982.0	1,308.9	1,166.8	926.9	1,471.0	1,041.0	1,723.5
Defense	483.6	387.1	488.5	617.9	936.5	816.7	454.3	1,034.6	571.4	1,122.3
Others	314.7	319.7	369.8	364.1	372.4	350.1	472.6	436.4	469.6	601.2
Materials and services	718.1	519.7	1,679.7	1,877.0	1,532.5	1,407.8	1,313.3	1,489.3	985.0	1,428.8
Defense	454.3	247.1	1,447.8	1,606.6	1,283.7	1,066.9	840.7	1,069.8	428.6	897.2
Others	263.8	272.6	231.9	270.4	248.8	340.9	472.6	419.5	556.4	531.6
Subsidies	0.0	0.0	0.0	0.0	25.0	137.9	0.0	0.0	0.0	0.0
Pensions	0.0	0.0	0.0	0.0	21.6	21.0	21.6	18.9	9.5	9.5
Interest	36.2	49.3	67.3	112.2	175.0	266.1	300.8	347.8	471.8	357.2
Domestic	36.2	49.3	62.9	100.9	157.0	202.5	210.0	239.2	316.6	255.5
External	0.0	0.0	4.4	11.3	18.0	63.7	90.8	108.7	155.2	101.7
Grants and contributions	122.1	137.0	176.3	242.7	301.1	287.6	339.9	329.0	197.9	197.9
Capital expenditure 1/	869.0	1,147.8	1,437.4	2,245.7	727.2	1,356.6	3,593.2	1,527.3	5,278.6	1,587.4
Central treasury	529.3	687.8	584.2	1,157.0	295.5	539.8	939.0	628.2	1,280.4	492.6
Externally financed	339.7	460.0	853.2	1,088.7	431.7	816.8	2,654.2	899.1	3,998.2	1,094.7
Net lending	-29.9	-2.5	-0.2	8.3	45.0	-98.5	-7.5	-6.4	-11.9	-11.9
Contingency/drought assistance	0.0	0.0	0.0	0.0	0.0	0.0	300.0	0.0	300.0	300.0
Domestic balance 2/	-789.2	-75.3	-1,672.5	-2,472.4	-1,578.4	-1,678.5	-1,959.1	-1,877.7	-776.7	-1,520.1
Overall balance, excl. special programs										
Excluding grants	-1,128.9	-535.3	-2,530.1	-3,572.4	-2,028.1	-2,559.0	-4,704.1	-2,885.4	-4,930.1	-2,716.5
Including grants	-650.3	-247.4	-2,010.7	-3,083.4	-823.3	-1,183.4	-364.6	-1,767.1	-1,435.1	-554.9
Special programs	208.6	32.7	90.7	142.0	1,167.7	1,521.5	3,819.5	955.0	1,465.1	2,161.5
Emergency Reconstruction Program (ERP)	0.0	0.0	0.0	0.0	198.0	648.4	2,534.7	463.8	231.6	206.1
External	0.0	0.0	0.0	0.0	0.0	628.8	2,434.8	426.6	218.2	197.1
Domestic	0.0	0.0	0.0	0.0	198.0	19.6	99.9	37.2	13.4	9.0
Demobilization	14.0	0.0	0.0	0.0	0.0	6.9	0.0	7.8	0.0	891.4
Humanitarian	194.6	32.7	90.7	142.0	969.7	866.3	1,284.8	483.4	1,233.5	1,064.0
Overall balance										
Excluding grants	-1,337.5	-568.0	-2,620.8	-3,714.4	-3,195.7	-4,080.5	-8,523.6	-3,840.4	-6,395.2	-4,878.0
Including grants	-858.9	-280.1	-2,101.4	-3,225.4	-1,991.0	-2,704.9	-4,183.9	-2,722.0	-2,900.2	-2,716.4
Financing	799.8	405.0	2,058.5	3,183.7	2,016.7	2,509.2	4,183.9	2,743.2	2,900.2	2,716.4
External (net)	54.9	206.3	204.2	521.0	535.0	1,046.6	2,120.3	918.9	1,754.9	772.7
Official (net)	54.7	204.8	193.9	335.1	386.7	964.5	2,120.3	671.4	1,915.8	980.4
Disbursements	54.7	204.8	193.9	340.5	392.5	983.7	2,424.3	718.6	2,012.4	1,141.4
Amortization	0.0	0.0	0.0	5.4	5.8	19.2	304.0	47.2	96.7	161.0
Other public borrowing (net)	0.0	0.0	4.4	184.3	57.9	4.5	0.0	-51.7	-158.7	-143.4
Exceptional financing	0.2	1.5	5.9	1.5	90.4	77.6	0.0	299.2	-2.1	-64.3
Domestic (net)	744.9	198.7	1,854.3	2,662.7	1,481.7	1,462.6	2,063.6	1,824.3	1,145.3	1,943.7
Banking system	739.9	178.7	1,703.9	2,565.4	1,989.5	1,512.3	1,883.6	1,809.6	1,010.3	1,876.2
Nonbank 3/	5.0	20.0	150.4	97.3	-507.8	-49.7	180.0	14.7	135.0	67.5
Errors and omissions/financing gap	59.1	-124.9	42.9	41.7	-25.8	195.7	0.0	-21.2	0.0	0.0
Memorandum items:										
Domestic expenditures 4/	2,174.1	2,098.1	3,361.2	4,367.9	3,686.7	3,664.9	4,043.2	4,169.1	4,118.5	4,395.9
Defense	937.9	634.2	1,936.3	2,224.5	2,220.3	1,883.6	1,295.0	2,104.4	1,000.0	2,019.5
Other domestic expenditures	1,236.2	1,463.9	1,424.9	2,143.4	1,466.4	1,781.3	2,748.2	2,064.7	3,118.5	2,376.4
Interest, net lending, and contingency	6.3	46.8	62.7	109.2	202.0	104.0	502.5	232.8	604.7	543.6
Core expenditures	1,229.9	1,417.1	1,362.2	2,034.2	1,264.4	1,677.3	2,245.7	1,831.9	2,513.8	1,832.8
Current	700.6	729.3	778.0	877.2	968.9	1,137.5	1,306.7	1,203.8	1,233.4	1,340.2
Capital	529.3	687.8	584.2	1,157.0	295.5	539.8	939.0	628.2	1,280.4	492.6
Poverty-related spending 5/	535.2	588.1	872.2	780.8	907.7	973.0	...	1,392.7	1,631.9	1,863.1
Current expenditure	142.1	253.2	294.6	303.8	296.0	314.0	...	330.9	392.3	519.3
Capital expenditure	393.1	334.9	577.6	477.0	611.7	659.0	...	1,061.8	1,239.5	1,343.8

Table 2. Eritrea: Summary of Government Operations, 1996-2003 (Concluded)

	1996	1997	1998	1999	2000	2001	2002		2003	
						Act.	Budget	Est.	Budget	Proj.
	(In percent of GDP, unless otherwise indicated)									
Total revenue and grants	42.0	46.5	39.9	39.9	53.4	43.3	73.8	37.8	55.8	45.2
Revenue	31.2	40.7	30.5	31.7	34.0	25.6	23.9	25.4	27.3	25.8
Tax revenue	18.7	19.3	17.7	17.0	15.8	16.5	17.3	17.0	14.4	15.8
Direct taxes	8.6	9.0	9.3	8.7	7.6	7.4	7.5	6.1	4.8	5.6
Indirect domestic taxes	4.1	4.3	3.6	4.0	3.8	3.8	4.6	4.1	3.6	3.9
Import duties and taxes	6.1	6.0	4.8	4.4	4.4	5.3	5.2	6.8	6.0	6.4
Nontax revenue	12.5	21.4	10.8	10.0	12.9	6.9	6.6	8.0	12.5	9.6
Extraordinary revenues	0.0	0.0	2.1	4.6	5.2	2.3	0.0	0.3	0.4	0.4
Grants	6.1	12.4	9.4	8.2	19.4	17.7	49.9	12.4	28.5	19.4
Private	0.0	0.0	0.0	1.0	2.1	0.5	0.3	0.2	0.5	0.5
Official	10.8	5.8	8.3	6.0	16.3	17.2	49.5	12.2	28.1	18.9
Humanitarian	3.8	3.9	0.6	1.5	2.3	11.1	14.8	5.4	10.1	9.5
Demobilization	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.0	5.3
Capital projects	6.5	5.7	4.6	6.1	3.5	5.9	30.6	6.7	18.0	4.0
Program	0.0	0.0	0.0	0.0	0.0	0.0	4.1	0.0	0.0	0.0
Expenditure and net lending (excluding special programs)	56.7	51.4	76.3	91.4	66.7	58.5	78.0	57.3	67.5	50.1
Current expenditure	37.7	28.4	50.3	53.7	54.3	42.3	33.3	40.5	22.1	33.3
Wages, salaries, and allowances	18.0	14.2	15.5	16.4	21.1	15.0	10.6	16.3	8.5	15.5
Defense	10.9	7.8	8.8	10.3	15.1	10.5	5.2	11.5	4.7	10.1
Others	7.1	6.4	6.7	6.1	6.0	4.5	5.4	4.8	3.8	5.4
Materials and services	16.2	10.4	30.4	31.4	24.7	18.1	15.1	16.5	8.0	12.8
Defense	10.2	5.0	26.2	26.9	20.7	13.7	9.7	11.8	3.5	8.0
Others	5.9	5.5	4.2	4.5	4.0	4.4	5.4	4.6	4.5	4.8
Subsidies	0.0	0.0	0.0	0.0	0.4	1.8	0.0	0.0	0.0	0.0
Pensions	0.0	0.0	0.0	0.0	0.3	0.3	0.2	0.2	0.1	0.1
Interest	0.8	1.0	1.2	1.9	2.8	3.4	3.5	3.9	3.9	3.2
Domestic	0.8	1.0	1.1	1.7	2.5	2.6	2.4	2.6	2.6	2.3
External	0.0	0.0	0.1	0.2	0.3	0.8	1.0	1.2	1.3	0.9
Grants and contributions	2.8	2.8	3.2	4.1	4.9	3.7	3.9	3.6	1.6	1.8
Capital expenditure 1/	19.6	23.1	26.0	37.5	11.7	17.5	41.3	16.9	43.1	14.2
Central treasury	11.9	13.8	10.6	19.3	4.8	6.9	10.8	7.0	10.5	4.4
Externally financed	7.7	9.2	15.4	18.2	7.0	10.5	30.5	10.0	32.6	9.8
Net lending	-0.7	-0.1	0.0	0.1	0.7	-1.3	-0.1	-0.1	-0.1	-0.1
Contingency/drought assistance	0.0	0.0	0.0	0.0	0.0	0.0	3.4	0.0	2.4	2.7
Domestic balance 2/	-17.8	-1.5	-30.2	-41.3	-25.5	-21.6	-22.5	-20.8	-6.3	-13.6
Overall balance, excl. special programs										
Excluding grants	-25.4	-10.8	-45.7	-59.7	-32.7	-32.9	-54.0	-31.9	-40.2	-24.4
Including grants	-14.7	-5.0	-36.4	-51.5	-13.3	-15.2	-4.2	-19.6	-11.7	-5.0
Special programs	4.7	0.7	1.6	2.4	18.8	19.6	43.9	10.6	12.0	19.4
Emergency Reconstruction Program (ERP)	0.0	0.0	0.0	0.0	3.2	8.3	29.1	5.1	1.9	1.8
External	0.0	0.0	0.0	0.0	0.0	8.1	28.0	4.7	1.8	1.8
Domestic	0.0	0.0	0.0	0.0	3.2	0.3	1.1	0.4	0.1	0.1
Demobilization	0.3	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.0	8.0
Humanitarian	4.4	0.7	1.6	2.4	15.6	11.1	14.8	5.4	10.1	9.5
Overall balance										
Excluding grants	-30.1	-11.4	-47.4	-62.1	-51.5	-52.5	-97.9	-42.5	-52.2	-43.7
Including grants	-19.4	-5.6	-38.0	-53.9	-32.1	-34.8	-48.1	-30.1	-23.7	-24.4
Financing	18.0	8.1	37.2	53.2	32.5	32.3	48.1	30.4	23.7	24.4
External (net)	1.2	4.1	3.7	8.7	8.6	13.5	24.4	10.2	14.3	6.9
Official (net)	1.2	4.1	3.5	5.6	6.2	12.4	24.4	7.4	15.6	8.8
Other public borrowing (net)	0.0	0.0	0.1	3.1	0.9	0.1	0.0	-0.6	-1.3	-1.3
Exceptional Financing	0.0	0.0	0.1	0.0	1.5	1.0	0.0	3.3	0.0	-0.6
Domestic (net)	16.8	4.0	33.5	44.5	23.9	18.8	23.7	20.2	9.4	17.4
Banking system	16.7	3.6	30.8	42.9	32.1	19.5	21.6	20.0	8.2	16.8
Nonbank 3/	0.1	0.4	2.7	1.6	-8.2	-0.6	2.1	0.2	1.1	0.6
Errors and omissions/Financing gap	1.3	-2.5	0.8	0.7	-0.4	2.5	0.0	-0.2	0.0	0.0
Memorandum items:										
Net donor support	12.0	9.9	11.8	11.6	22.5	29.6	20.3	19.6	43.7	27.7
Grants	10.8	5.8	8.3	6.0	16.3	17.2	12.6	12.2	28.1	18.9
Net official disbursements	1.2	4.1	3.5	5.6	6.2	12.4	7.7	7.4	15.6	8.8
Exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net donor support (in millions of U.S. dollars)	83.9	68.4	88.4	85.0	145.4	211.0	126.8	126.8	321.5	205.1
Grants	75.3	40.0	62.1	43.9	105.1	122.5	78.7	78.7	206.5	139.9
Net official disbursements	8.6	28.4	26.3	41.1	40.3	88.5	48.1	48.1	115.0	65.1
Exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic expenditures 4/	49.0	42.2	60.8	73.0	59.5	47.2	46.4	46.2	33.6	39.4
Defense	21.1	12.7	35.0	37.2	35.8	24.2	14.9	23.3	8.2	18.1
Other domestic expenditures	27.9	29.4	25.8	35.8	23.6	22.9	31.6	22.9	25.5	21.3
Interest, net lending, and contingency	0.1	0.9	1.1	1.8	3.3	1.3	5.8	2.6	4.9	4.9
Core expenditures	27.7	28.5	24.6	34.0	20.4	21.6	25.8	20.3	20.5	16.4
Current	15.8	14.7	14.1	14.7	15.6	14.6	15.0	13.3	10.1	12.0
Capital	11.9	13.8	10.6	19.3	4.8	6.9	10.8	7.0	10.5	4.4
Poverty-related spending 5/	12.1	11.8	15.8	13.1	14.6	12.5	...	15.4	13.3	16.7
Current expenditure	3.2	5.1	5.3	5.1	4.8	4.0	...	3.7	3.2	4.7
Capital expenditure	8.9	6.7	10.4	8.0	9.9	8.5	...	11.8	10.1	12.0

Sources: Ministry of Finance; and staff estimates and projections.

1/ Excludes expenditures on ERP.
2/ Total revenue less expenditures, excluding externally financed outlays, external interest, and expenditures for special programs.
3/ Nonbank financing comprises change in cash holdings and net privatization receipts.
4/ Domestic expenditures are wages, materials and services, grants and contributions, domestic interest, pensions, non-ERP central treasury capital projects, and non-ERP-related net lending and contingencies.
5/ Including spending for agriculture, fisheries, education, and health.

Table 3. Eritrea: Monetary Survey, 1996-2003

	1996 Dec.	1997 Dec.	1998 Dec.	1999 Dec.	2000 Dec.	2001 Mar.	2001 Jun.	2001 Sep.	2001 Dec.	2002 Mar.	2002 Jun.	2002 Sep.	2002 Dec. Est.	2003 Dec. Proj.
							(In millions of nakfa)							
Net foreign assets	1,173	1,855	789	951	553	410	361	861	1,220	730	896	910	1,232	1,495
Foreign assets	1,303	2,102	1,084	1,391	1,299	1,227	1,530	2,239	2,831	2,247	2,455	2,648	2,993	4,019
Foreign liabilities	129	247	294	440	745	816	1,169	1,378	1,610	1,518	1,559	1,738	1,761	2,524
Net domestic assets	2,640	2,937	4,874	7,027	8,464	8,657	9,134	9,304	10,182	11,084	11,488	12,118	12,275	15,598
Net domestic credit	2,957	3,485	5,985	8,364	10,178	10,343	9,439	9,927	10,943	11,365	11,906	12,580	13,209	16,366
Net claims on the central government	1,405	1,517	3,221	5,773	7,766	7,825	6,844	7,183	8,101	8,362	8,747	9,323	9,834	11,711
Excl. customs deposit accounts	1,609	1,517	3,221	5,786	7,776	7,844	6,866	7,207	8,102	8,386	8,774	9,325	9,841	11,718
Credit to the economy	1,552	1,969	2,765	2,591	2,412	2,518	2,595	2,744	2,842	3,002	3,159	3,257	3,375	4,655
Credit to public enterprises	459	385	265	697	402	395	322	287	349	383	144	114	125	155
Credit to private sector	1,094	1,584	2,499	1,870	1,985	2,100	2,249	2,442	2,483	2,610	3,015	3,143	3,249	4,501
Claims on nonbank financial institutions	0	0	0	25	24	23	24	14	10	10	0	0	0	0
Valuation	0	0	283	465	492	492	492	692	454	457	468	463	485	651
Other items (net)	-317	-549	-1,394	-1,802	-2,206	-2,179	-797	-1,315	-1,215	-737	-886	-926	-1,419	-1,419
Broad money	3,814	4,792	5,663	7,977	9,018	9,067	9,496	10,165	11,402	11,813	12,384	13,028	13,507	17,094
M2	3,661	4,710	5,577	7,554	8,728	8,740	9,114	9,626	10,950	11,270	11,857	12,479	13,031	16,416
M1	1,488	2,024	2,307	3,465	3,931	3,882	3,999	4,342	5,036	5,074	5,208	5,680	5,949	7,386
Currency outside banks	0	574	825	1,138	1,468	1,410	1,515	1,635	1,868	1,919	2,037	2,165	2,215	2,769
Demand deposits	1,488	1,450	1,481	2,327	2,463	2,472	2,484	2,707	3,169	3,155	3,171	3,515	3,735	4,617
Time and savings deposits	2,173	2,686	3,271	4,089	4,797	4,857	5,115	5,285	5,914	6,196	6,649	6,799	7,082	9,030
Foreign currency deposits	152	82	86	423	290	327	382	539	452	543	527	549	476	678
Reserve money	2,500	4,718	3,005	4,241	4,564	4,602	3,740	3,788	4,409	4,270	4,232	4,539	4,955	4,744
Excess reserves	1,763	3,241	1,192	1,567	1,453	1,485	488	149	397	163	-81	-11	332	244
						(Annual change in percent of beginning-of-period broad money stock)								
Net foreign assets	-1.2	17.9	-22.2	2.9	-5.0	-3.6	1.0	4.9	7.4	3.5	5.6	0.5	0.1	2.0
Net domestic assets	18.6	7.8	40.4	38.0	18.0	19.4	16.6	15.2	19.0	26.8	24.8	27.7	18.4	24.6
Net domestic credit	34.1	13.8	52.2	42.0	22.7	23.4	7.2	6.3	8.5	11.3	26.0	26.1	19.9	23.4
Net claims on central government	20.0	2.9	35.6	45.1	25.0	25.6	2.1	0.5	3.7	5.9	20.0	21.0	15.2	13.9
Credit to the economy	14.1	10.9	16.6	-3.1	-2.3	-2.2	5.1	5.8	4.8	5.3	5.9	5.1	4.7	9.5
Of which: credit to private sector	14.2	12.8	19.1	-11.1	1.4	0.8	6.8	5.8	5.5	5.6	8.1	6.9	6.7	9.3
Valuation	0.0	0.0	5.9	3.2	0.3	0.3	0.3	2.7	-0.4	-0.4	-0.3	-2.2	0.3	1.2
Other items (net)	-15.5	-6.1	-17.6	-7.2	-5.1	-4.4	9.0	6.2	11.0	15.9	-0.9	3.8	-1.8	0.0
Broad money	17.5	25.7	18.2	40.9	13.0	15.8	17.5	20.1	26.4	30.3	30.4	28.2	18.5	26.6
M2	17.5	27.5	18.1	34.9	14.7	14.5	15.7	16.6	24.6	27.9	28.9	28.1	18.3	25.1
M1	9.7	14.1	5.9	20.5	5.8	7.1	6.4	7.2	12.3	13.1	12.7	13.2	8.0	10.6
Currency outside banks	...	...	5.2	5.5	4.1	3.5	2.6	2.9	4.4	5.6	5.5	5.2	3.0	4.1
Demand deposits	9.7	14.1	0.7	14.9	1.7	3.6	3.8	4.3	7.8	7.5	7.2	8.0	5.0	6.5
Time and savings deposits	7.9	13.4	12.2	14.4	8.9	7.4	9.3	9.4	12.4	14.8	16.2	14.9	10.2	14.4
Foreign currency deposits	-0.1	-1.8	0.1	6.0	-1.7	1.3	1.8	3.5	1.8	2.4	1.5	0.1	0.2	1.5
Memorandum items:						(Annual percentage change, unless otherwise indicated)								
Reserve money	86.6	88.7	-36.3	41.1	7.6	11.0	-11.4	-14.6	-3.4	-7.2	13.2	19.8	12.4	-4.3
Broad money	17.5	25.7	18.2	40.9	13.0	15.8	17.5	20.1	26.4	30.3	30.4	28.2	18.5	26.6
M2	18.4	28.6	18.4	35.4	15.5	14.9	16.2	17.1	25.5	28.9	30.1	29.6	19.0	26.0
Credit to the economy	42.0	26.8	40.4	-6.3	-6.9	-6.4	18.8	21.7	17.9	19.2	21.7	18.7	18.7	38.0
Excess reserves/broad money (in percent)	46.2	67.6	21.1	19.6	16.1	16.4	5.1	1.5	3.5	1.4	-0.7	-0.1	2.5	1.4

Sources: Bank of Eritrea; and staff estimates and projections.

Table 4. Eritrea: Analytical Presentation of the Banking Sector Accounts, 1996-2003
(In millions of nakfa)

	1996	1997	1998	1999	2000	2001				2002				2003
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec. Est.	Dec. Proj.
Bank of Eritrea														
Net foreign assets	920	1,734	524	518	247	236	201	336	524	479	309	242	293	288
Foreign assets	931	1,746	532	537	386	376	494	543	716	668	499	434	487	508
Of which : international reserves	699	1,728	525	521	370	360	478	524	697	649	480	416	468	486
Foreign liabilities	11	11	8	19	139	140	293	207	192	189	191	192	195	220
Net domestic assets	1,581	2,984	2,481	3,722	4,317	4,366	3,539	3,452	3,885	3,791	3,924	4,296	4,662	4,439
Net domestic credit	1,622	1,939	1,790	3,154	4,061	4,143	3,360	3,392	3,900	3,801	4,002	4,544	5,019	4,777
Net claims on central government	1,601	1,626	1,336	2,964	3,551	3,645	2,879	2,753	3,239	3,123	3,271	3,837	4,248	3,961
Excl. customs deposit accounts	1,609	1,626	1,336	2,977	3,561	3,664	2,901	2,776	3,240	3,146	3,297	3,839	4,255	3,968
Credit to central government	1,812	2,009	1,788	3,780	4,145	4,152	3,678	3,685	4,043	4,146	4,397	4,899	5,375	5,088
Deposits of central government	211	383	452	816	594	508	799	933	805	1,023	1,126	1,061	1,127	1,127
Credit to the economy	60	102	75	95	161	156	145	190	117	212	214	190	193	239
Credit to commercial banks	100	235	381	371	448	453	457	597	653	588	597	605	624	624
Other deposits in foreign currency	-139	-24	-3	-276	-100	-110	-122	-148	-108	-122	-79	-88	-46	-46
Valuation	15	189	279	378	391	391	391	489	251	252	257	257	265	283
Other items (net)	-56	856	412	190	-134	-167	-212	-429	-266	-262	-336	-505	-621	-621
Reserve money	2,500	4,718	3,005	4,241	4,564	4,602	3,740	3,788	4,409	4,270	4,232	4,539	4,955	4,744
Commercial banks														
Net foreign assets	254	121	265	432	306	174	160	525	697	250	587	667	939	1,208
Foreign assets	371	356	551	854	913	851	1,036	1,696	2,115	1,580	1,956	2,213	2,505	3,512
Foreign liabilities	118	235	286	421	607	676	876	1,172	1,418	1,329	1,368	1,546	1,566	2,304
Net domestic assets	3,414	3,978	4,545	5,937	7,106	7,275	7,649	7,654	8,643	9,413	9,500	9,958	10,226	12,923
Net domestic credit	3,691	5,572	6,346	7,842	9,075	9,185	8,133	8,337	9,388	9,684	9,839	10,172	10,803	13,437
Net claims on central government	-196	-109	1,884	2,809	4,215	4,180	3,965	4,431	4,862	5,240	5,476	5,486	5,586	7,750
Of which: holding of government securities	0	0	2,000	2,706	4,062	4,062	3,866	4,206	4,611	5,066	5,266	5,266	5,340	7,504
Credit to the economy	1,493	1,867	2,689	2,496	2,250	2,362	2,450	2,554	2,725	2,791	2,945	3,067	3,181	4,416
Credit to public enterprises	459	385	265	697	402	395	322	287	349	383	144	114	125	155
Credit to private sector	1,034	1,482	2,424	1,775	1,823	1,944	2,104	2,252	2,367	2,398	2,801	2,954	3,056	4,262
Claims on nonbank financial institutions	0	0	0	25	24	23	24	14	10	10	0	0	0	0
Net claims on the Bank of Eritrea	2,394	3,814	1,773	2,537	2,610	2,643	1,718	1,353	1,801	1,654	1,418	1,619	2,036	1,270
Total reserves	2,494	4,050	2,154	2,908	3,058	3,095	2,175	1,950	2,453	2,242	2,014	2,225	2,660	1,894
Required reserves	731	808	945	1,244	1,444	1,447	1,510	1,558	1,799	1,848	1,928	2,033	2,147	1,357
Excess reserves	1,763	3,241	1,192	1,567	1,453	1,485	488	149	397	163	-81	-11	332	244
Foreign currency deposits	0	0	16	97	161	164	177	244	257	231	168	202	181	294
Credit from the Bank of Eritrea	-100	-235	-381	-371	-448	-453	-457	-597	-653	-588	-597	-605	-624	-624
Valuation	0	0	4	87	102	102	102	203	203	205	211	206	220	283
Other items (net)	-276	-1,594	-1,806	-1,993	-2,071	-2,011	-586	-886	-949	-476	-550	-420	-797	-797
Deposit liabilities to nonbank residents	3,668	4,100	4,810	6,369	7,412	7,450	7,809	8,179	9,339	9,664	10,088	10,626	11,165	14,197
Local currency deposits	3,655	4,041	4,727	6,222	7,222	7,233	7,549	7,788	8,995	9,242	9,640	10,165	10,736	13,566
Demand deposits	1,481	1,355	1,456	2,133	2,425	2,375	2,434	2,503	3,081	3,046	2,990	3,366	3,654	4,536
Time and savings deposits	2,173	2,686	3,271	4,089	4,797	4,857	5,115	5,285	5,914	6,196	6,649	6,799	7,082	9,030
Foreign currency deposits	14	58	83	147	190	217	260	391	345	422	448	460	429	631

Sources: Bank of Eritrea; and staff estimates and projections.

Table 5. Eritrea: Balance of Payments, 1997-2003

	1997	1998	1999	2000	2001 Prel.	2002 Est.	2003 Proj.
	(In millions of U.S. dollars)						
Trade balance	-441.1	-498.6	-474.5	-433.5	-516.7	-481.7	-539.2
Exports, f.o.b	53.5	28.2	20.1	36.7	19.9	51.8	35.2
Imports, c.i.f.	494.6	526.8	494.6	470.3	536.7	533.4	574.4
Food and live animals	83.3	62.4	91.7	117.3	153.9	103.1	171.2
Refined petroleum	46.4	21.4	33.2	42.4	49.2	48.5	63.1
Defense	22.9	141.7	89.5	103.0	133.7	97.9	76.6
Other	342.0	301.3	280.2	207.6	199.8	283.9	263.4
Services (net)	55.4	12.9	-57.3	32.4	94.2	102.3	106.6
Receipts	149.8	82.2	45.6	60.7	127.5	132.6	141.3
Payments	94.4	69.3	102.8	28.3	33.4	30.3	34.7
Income (net)	-3.4	4.3	6.1	-1.4	-4.6	-6.1	-7.1
Of which: interest payments due	0.5	1.6	3.3	4.6	5.3	6.1	6.8
Of which : government interest due	0.2	0.6	1.0	1.5	2.0	2.6	3.1
Private transfers (net)	352.1	245.4	243.6	195.7	175.0	205.6	222.9
Receipts	354.4	247.7	254.7	200.2	180.4	211.0	228.6
Payments	2.3	2.3	11.1	4.5	5.4	5.5	5.7
Current account, excluding official transfers	-37.0	-235.9	-282.1	-206.8	-252.1	-179.9	-216.8
Official transfers (net)	51.4	58.8	77.4	102.4	120.8	80.3	139.9
Grant for relief imports	50.0	15.7	65.9	101.0	79.5	34.6	70.7
Of which: grant for food imports	4.4	0.0	21.5	62.3	57.4	27.1	55.8
Emergency Reconstruction Program	...	...	...	0.0	1.3	9.0	0.0
Of which: balance of payments support	...	...	...	...	...	...	...
Other grants	1.4	43.0	11.4	1.3	40.0	36.6	69.2
Current account, including official transfers	14.4	-177.1	-204.7	-104.5	-131.4	-99.6	-76.8
Capital account (net)	0.0	2.7	0.6	0.0	7.3	3.6	3.6
Financial account	90.5	77.7	205.0	98.7	94.8	64.6	74.8
Official long-term capital	28.9	64.4	109.6	50.4	101.4	78.7	67.2
Loan disbursements (committed)	28.9	64.4	110.2	51.0	103.1	82.1	77.9
Emergency Reconstruction Program	...	...	...	...	56.4	22.7	13.1
Balance of payments support	...	...	...	...	...	...	...
Demobilization	...	...	...	...	0.0	0.5	20.0
Other public sector projects	9.0	64.4	110.2	51.0	46.8	58.9	44.8
Amortization payments	0.0	0.0	0.7	0.6	1.8	3.4	10.7
Other public borrowings (net)	0.0	0.6	22.6	5.7	0.0	-18.2	-5.3
Foreign direct investment	38.7	30.4	83.0	27.9	12.1	20.0	22.0
Portfolio investment (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term capital (net)	22.8	-17.8	-10.2	14.7	-18.7	-15.9	-9.2
Errors and omissions	41.8	-77.3	-15.6	-9.5	36.5	-7.6	0.0
Overall balance	146.7	-174.1	-14.7	-15.2	7.2	-39.0	1.6
Financing	-146.7	174.1	14.7	15.2	-7.2	39.0	-1.6
Change in net foreign assets of Bank of Eritrea	-146.9	173.3	14.5	5.8	-14.3	17.5	2.7
Gross reserve change of Bank of Eritrea (- increase)	-113.1	174.3	14.7	17.7	-13.9	17.4	2.7
IMF (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other liabilities	-33.8	-1.1	-0.2	-11.8	-0.4	0.1	0.0
Change in arrears (+ increase)	0.2	0.8	0.2	0.5	0.6	14.4	-4.3
Exceptional financing	0.0	0.0	0.0	9.0	6.5	7.1	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	(In units indicated)						
Memorandum items:							
Current account, excluding official transfers (in millions of U.S. dollars)	-37.0	-235.9	-282.1	-206.8	-252.1	-179.9	-216.8
(as percentage of GDP)	-5.4	-31.5	-38.4	-32.0	-35.4	-27.8	-29.3
Current account, including official transfers (in millions of U.S. dollars)	14.4	-177.1	-204.7	-104.5	-131.4	-99.6	-76.8
(as percentage of GDP)	2.1	-23.6	-27.9	-16.2	-18.4	-15.4	-10.4
Gross reserves in convertible currency (in millions of U.S. dollars)	243.3	69.0	54.3	36.6	50.6	33.1	30.5
(in months of imports of goods and services)	5.0	1.4	1.1	0.9	1.1	0.7	0.6
Net donor support (as percentage of GDP)	11.6	16.4	25.5	23.7	31.2	24.6	28.0
Grants	7.4	7.8	10.5	15.8	16.9	12.4	18.9
Net official disbursements	4.2	8.6	14.9	7.8	14.2	12.2	9.1
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GDP (in millions of U.S. dollars)	690.9	749.9	733.7	645.9	712.9	647.0	741.1
Imports of goods and services (in millions of U.S. dollars)	589.0	596.1	597.4	498.6	570.0	563.7	609.0
Imports of nondefense goods (growth rate; in percent)	...	-18.4	5.2	-9.3	9.7	8.1	14.3
Imports of nonfood & nondefense goods (growth rate; in percent)	...	-11.9	-7.0	-25.9	-3.8	42.1	-7.2
Net present value (NPV) of external debt (in millions of U.S. dollars)	48.3	88.6	171.2	206.0	256.6	283.8	305.2
NPV of external debt-to-exports ratio (in percent) 1/	25.2	51.7	135.4	225.9	247.8	198.3	180.1
Debt service/exports of goods and nonfactor services (in percent) 1/	0.3	0.8	5.7	3.8	5.3	15.1	12.9

Sources: Bank of Eritrea; and staff estimates and projections.
1/ Three-year average of exports of goods and services used.

Eritrea: Relations with the Fund
(As of February 28, 2003)

I. **Membership Status:** Joined July 6, 1994, Article XIV

II. **General Resources Account:**	SDR Million	% of Quota
Quota	15.90	100.0
Fund holdings of currency	15.90	100.0
Reserve position in Fund	0.01	0.0

III. **SDR Department:**	SDR Million
Net cumulative allocation	0.00
Holdings	0.00

IV. **Outstanding Purchases and Loans** None.

V. **Financial Arrangements** None.

VI. **Projected Obligations to the Fund** (SDR million; based on existing use of resources and present holdings of SDRs): None.

VII. **Exchange Rate Arrangement**

Eritrea introduced a national currency—the nakfa—on November 22, 1997. The new currency replaced the Ethiopian birr, which had served as the provisional legal tender since Eritrea's independence. Initially, the nakfa traded at parity with the birr (some ERN 5 per U.S. dollar). Effective May 1, 1998, the authorities put in place a mechanism to determine the exchange rate in the market consisting of 2 commercial banks and 12 foreign exchange bureaus. In the course of the border conflict with Ethiopia, the nakfa came under pressure, which forced the authorities to fix its rate as of July 19, 2000 at ERN 9.60 per U.S. dollar. At the same time, the foreign exchange bureaus were only allowed to sell foreign exchange to the Bank of Eritrea. Since August 2001, in principle, bureaus and banks have been legally free to buy and sell foreign exchange at market-determined exchange rates. However, after depreciating to ERN 13.8 per U.S. dollar in September 2001, the buying rate has remained relatively constant, and neither bureaus nor banks have been selling foreign exchange in the retail market. Meanwhile, growing foreign exchange shortages and selective access to official sources of foreign exchange that excludes a large part of private bona fide current transactions have resulted in a dual exchange market with a 60 percent parallel market premium. This constitutes a multiple currency practice subject to Article VIII, Section 3 of the Fund's Articles of Agreement and give rise to exchange restrictions subject to Article VIII, Section 2(a).

VIII. Article IV Consultation

The last Article IV consultation discussions were held during May 29–June 15, 2001 on the standard 12-month cycle. The staff report (SM/01/338; 11/12/01) and a statistical appendix (SM/01/339; 11/12/01) were discussed by the Executive Board on November 12, 2001.

IX. Recent Technical Assistance

Department	Purpose	Time of delivery
FAD	Drafting of tax reform plan	Nov. 19–Dec. 2, 1999
FAD	Procurement component of Finance Act	Aug. 30–Sep. 27, 2000
STA	Assessment of statistical system	Oct. 23–Nov. 3, 2000
FAD	Fiscal management	Nov. 27–Dec. 12, 2000
MAE	Long-term banking supervision advisor	Mar. 15, 2001–Jun. 15, 2003
FAD	Long-term tax administration advisor	Apr. 12, 2001–Oct. 18, 2002
STA	Money and banking statistics	Apr. 25–May 9, 2001
FAD	Long-term treasury advisor	June 9, 2002–Jan. 10, 2003
STA	Money and banking statistics	Nov. 13–26, 2002

Eritrea: Relations with the World Bank Group

(As of February 28, 2003)

1. The Bank's activities in Eritrea as an independent country date back only to 1992. As of February 28, 2003, the World Bank has committed to Eritrea US$385.4 million, of which US$219.4 million has been disbursed. The World Bank's current portfolio in Eritrea consists of eight operations with an undisbursed balance at the end of February 2003 of about US$170 million. Total disbursements in FY 02 were US$52 million.

2. Following the signing of the Cessation of Hostilities Agreement in July 2000, the World Bank resumed lending to Eritrea for selective high-impact operations. An Interim Support Strategy was approved in November 2000.

Education and health

3. The Bank currently has five ongoing human development operations in Eritrea. In FY 98, a Health Project (US$18.3 million) and a Human Resource Development Project (US$53 million) were approved. Following the resumption of lending, the Bank's Board approved three new projects in FY 01 for a total commitment of US$170 million. These included an Early Childhood Development Project (US$40 million); an Emergency Reconstruction Project (US$90 million), which aims to assist war-affected households and enterprises and rebuild key economic and social infrastructure; and an HIV/AIDS, Malaria, Sexually Transmitted Diseases, and Tuberculosis Control Project (HAMSET) (US$40 million).

Social protection

4. Given the importance of demobilization to the peace process and economic recovery in Eritrea, the Board approved in May 2002, a US$60 million credit in support of an Emergency Demobilization and Reintegration Program. This will finance the demobilization of 60,000 soldiers, and constitutes the first phase of a three-phase Demobilization and Reintegration Program.

A. Transport

5. The Bank has now only one ongoing operation in this sector: a Ports Rehabilitation Credit (US$30.3 million), which was approved in FY 98. The closing date was recently extended to June 2005 to allow implementation of two civil works contracts. The Roads Engineering Credit closed in June 2002.

B. Environment

6. A Cultural Assets Rehabilitation Learning Innovation Loan (US$5 million) was approved in July 2001 to assist the government of Eritrea in testing and developing the means

for more fully integrating the conservation and management of cultural assets into local and national economic development, as it begins the process of rebuilding its economy.

Lending pipeline

7. For FY 03, the Bank is preparing two operations: an Education Sector Improvement Project (US$35 million), which aims to expand enrollment in basic education and improve the quality of basic and secondary education; and an emergency operation on a grant basis to help the government address the impact of the drought. Other projects in the pipeline include the Community Development Program, which will be the successor to the highly rated Community Development Fund, a Power Distribution Project, and a Road Sector Development Project.

Nonlending services

8. The Bank is providing significant nonlending assistance through close policy dialogue with the government and the preparation of various studies, including a Country Economic Memorandum, a Health Sector Note/Health Strategic Options, an Education Sector Note, the RPED-Trade and Investment Study, pension reform, and a Country Procurement Assessment Report. An interim poverty reduction strategy paper (I-PRSP) outlining the government's long-term development strategy is expected to be completed in FY 4, as well as a Transitional Support Strategy.

MIGA, the IFC, and the WBI

9. MIGA does not have any exposure in Eritrea, but the country is a priority, especially given its conflict-affected status. MIGA hopes that peace with Ethiopia will produce conditions enabling increased foreign direct investment flows and opportunities for MIGA to support foreign investment in Eritrea.

10. The IFC is a partner in one investment project in a vehicle assembly plant (Tesinma) for $0.94 million. The IFC has not made any new investment in Eritrea since 1997. During the border conflict with Ethiopia, the IFC's focus shifted to providing technical assistance in the fish, marble and granite, and banking industries. At the request of the government, a technical assistance project to assist the Eritrean Chamber of Commerce was also undertaken. The PSAS is negotiating a mandate to privatize Eritrea's fixed-line telecommunications carrier.

11. WBI activity in Eritrea has been limited to date. However, the WBI is planning an initial visit to Eritrea in May 2003 to review capacity-building needs.

Summary of Statement of IDA Credits

(As of February 28, 2003; in millions of U.S. dollars)

Borrower / purpose	Principal	Disbursed	Undisbursed
3 projects closed	47.69	47.69	0
Ports Rehabilitation Project	30.30	14.60	15.66
Health Project	18.30	9.30	8.55
Human Resources Development Credit	53.00	48.5	2.33
Integrated Early Childhood Dev. Project	40.00	6.31	32.95
Emergency Reconstruction	90.00	79.49	10.05
HIV/AIDS Malaria STDs & TB Control	40.00	11.99	30.51
Cultural Assets Rehabilitation Project	5.00	0.53	4.91
Emergency Demobilization and Reintegration Project	60.00	1.02	64.80
Total (for 8 active credits)	336.60	171.75	169.77
Repayments	0.00		

Statement of IFC Investments

		Committed IFC			Disbursed IFC		
FY Approval	Company	Loan	Equity	Partic	Loan	Equity	Partic
1997	SEF Tesinma (car assembly)	0.40	0.21	0.00	0.40	0.21	0.00

Contact Information

Makhtar Diop
Country Director (Eritrea, Kenya, and Somalia
World Bank, Kenya
Upper Hill Road
P.O. Box 30577
Nairobi, Kenya
MSN: JB3-100
Phone: (254-2) 260 441, fax: 260 380/381
e-mail: mdiop2@worldbank.org

Sumana Dhar
Economist (Eritrea)
PREM2 African Region
MSN: J 10-1004
Phone: (202) 473-8084
Fax: (202) 473-8262
e-mail: sdhar3@worldbank.org

Eritrea: Statistical Issues

Despite some improvements in data standards in recent years, the evaluation of economic developments and policies continues to be hampered by the lack of timely and reliable statistics. The reasons for this are manifold but include above all a severe shortage of manpower—in good measure as a result of the slow implementation of the demobilization and of the drafting of officials into the National Service program—and the absence of a functioning statistical process with established mechanisms for cooperation and coordination among the various government agencies producing the administrative data. However, the government has drafted and submitted for parliamentary approval a Statistical Act, which aims at strengthening capacity in, and increasing the autonomy of, the National Statistics and Evaluation Office (NSEO). The introduction of Eritrea's country page in *International Financial Statistics (IFS)* is envisaged in May 2003.

Real sector

There are no official national accounts statistics in Eritrea, and the data sources to compile national accounts are scarce. The technical assistance program supported by the Norwegian government was interrupted by the dispute with the European Union (EU) in September 2001. Lately, the authorities have requested technical assistance (TA) from the East Africa Regional Technical Assistance Center (AFRITAC) to improve national accounts, prepare General Dissemination System (GDDS) metadata, and develop key economic indicators. The authorities have recently completed the first household income and expenditure survey (HIES), which would allow the compilation of a national consumer price index.

Government finance

Some progress has been made in the compilation of government finance data in recent years. However, no government finance statistics (GFS) data are reported for publication in the IFS or in the *Government Finance Statistics Yearbook (GFSY)*. During the second half of 2002, an IMF resident advisor assisted the authorities in strengthening the treasury's cash management system. Furthermore, the central treasury is planning to introduce fiscal accounting on an accrual basis to replace the current cash basis. TA has been requested from East AFRITAC to improve the budget process and introduce a GFS-based economic and functional classification system for accounting and budget management.

Monetary accounts

The authorities established a separate unit for compilation of monetary and financial statistics shortly after independence. The compilation system was aligned with the new *Monetary and Financial Statistics Manual (MFSM)* with TA from the Fund in April–May 2001. In addition to preparing the introduction of a country page in the *IFS*, a mission in November 2002 assisted the authorities in solving many of the methodological problems in the accounts of the commercial banks. However, there are still shortcomings with respect to the application of the residency criterion and the classification of the public sector accounts. In mid-2001, the Bank of Eritrea began reporting the monetary survey to the Fund on a monthly basis. However, timely submission to the Fund has been impaired by infrequent submission of commercial banks, data to the central bank. In March 2003, STA completed the necessary steps for the introduction of Eritrea's country page in *IFS*, and is waiting for the approval from the authorities for its publication.

Balance of payments

Recording of the balance of payments conforms with the fifth edition of the *Balance of Payments Manual*. However, the compilation of balance of payments statistics has recently been severely hampered by shortages of manpower in the statistical unit of the central bank. Furthermore, the lack of regular data transmission between relevant agencies hampers compilation of timely and reliable data. As a result, the balance of payments has not been updated since mid-2002.

Eritrea: Core Statistical Indicators
(As of March 15, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/Debt Service
Date of latest observation	1/31/03	1/31/03	1/31/03	1/31/03	11/31/02	N/A	12/31/02	6/30/02	6/30/02	12/31/02	12/31/02	12/31/02
Date received	2/25/03	2/25/03	2/25/03	2/25/03	1/18/03	N/A	3/18/03	1/18/03	1/18/03	3/18/03	1/18/03	2/15/02
Frequency of data 1/	M	M	M	M	M	N/A	M	Q	Q	M	Y	Y
Frequency of reporting 2/	V,M	V,M	V,M	V,M	V,M	N/A	V,O	V,O	V,O	V,O	V,O	V,O
Source of update 3/	A	A	A	A	A	N/A	A	A	A	A	A	A
Mode of reporting 4/	V,E	V,E	V,E	V,E	V,E	N/A	V,C	V,C	V,C	V,C	V,C	V,C
Confidentiality5/	B	B	B	B	B	N/A	B	B	B	B	B	B
Frequency of publication 6/	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

1/ D = Daily; M = Monthly; Q = Quarterly; A = Annually.
2/ V = Article IV consultation mission or staff visit; O = upon request from the staff; M = monthly
3/ A = Central Bank or Ministry of Finance.
4/ V = Article IV consultation mission or staff visit; C = facsimile; E = electronic
5/ B = for use by the staff and the Executive Board.
6/ None of the data have been published yet.

Eritrea: Selected Social and Demographic Indicators

Population characteristics	
Population (in millions)	4.2 (2001)
Growth rate (percent per annum)	2.6 (2001)
Share of rural population (percent)	80.9 (2001)
Density (per square kilometer)	35.7 (2001)
Life expectancy at birth (years)	52.0 (2000)
Income	
GDP per capita (in U.S. dollars)	
At official exchange rate (ERN 14 per U.S. dollar)	154
At parallel market rate (ERN 22 per U.S. dollar)	98
Health	
Infant mortality rate (per 1,000 live births)	59.6 (2000)
Access to immunization (measles; percent of population)	88.2 (2000)
Population per physician	30,000 (1999)
Population per hospital bed	1,333 (1998)
Access to safe water (percent)	46.0 (2000)
Nutrition	
Daily calories per capita	1,750 (1995)
Education	
Adult literacy rate (percent)	55.7 (2001)
Primary school enrollment (percent of relevant population)	61.2 (2000)
Secondary school enrollment (percent of relevant population)	28.2 (2000)
Pupil-teacher ratio, primary schools	47.5 (2000)

Sources: World Bank; and Eritrean authorities.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Eritrea

On May 2, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the 2003 Article IV consultation with Eritrea.[1]

Background

Eritrea is confronted with a wide range of serious economic challenges, including crisis management related to the drought and macroeconomic stabilization in the immediate term and the move toward a peacetime economy in support of growth and poverty reduction over the medium term. Addressing these challenges will require a combination of decisive crisis management, sound macroeconomic and development policies, and extensive donor support to lay the foundations for higher economic growth and poverty reduction over the medium term.

Among the immediate challenges, the most critical is the management of the worst drought since the country's independence which has reduced crop production to about a quarter of the average level observed over the past 10 years and threatens the lives of some 1.4 million Eritreans, about a third of the population. Donor response to the joint Eritrean and UN Consolidated Inter-Agency Appeal has been weak, and the authorities have had to take alternative action to prevent starvation, including external borrowing.

Macroeconomic performance has been seriously impaired by the drought and the lingering effects of the border conflict with Ethiopia during 1998-2000, which has resulted in large-scale destruction of infrastructure and dislocation of the population. The authorities have also remained concerned about the unresolved border issue and have only hesitatingly begun to implement the donor-supported demobilization program for

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

some 200,000 combatants. Reflecting these factors, economic growth in 2002 was negative at -1.2 percent, against 8.7 percent in 2001. The weakness of the economy and tight supply situation resulted in a sharp acceleration of inflation, with consumer prices rising by 24 percent by end 2002, compared with 8 percent at end-2001.

Unsustainably large macroeconomic imbalances persisted in 2002 despite some reductions in the fiscal and external current account deficits. Because of substantially lower externally financed capital spending, fiscal policy turned out to be much less expansionary than foreseen under the approved budget. In the event, the overall fiscal deficit, including special programs and grants, amounted to some 30 percent of GDP, compared with 35 percent of GDP in 2001. As in previous years, covering the government deficit required a large increase in domestic monetary financing, which contributed to inflation and put additional pressure on the external balances, foreign reserves, and the exchange rate. The external current account deficit nevertheless declined to 15 ½ percent of GDP in 2002 from 18 ½ percent in 2001, owing mainly to an increase in private transfer receipts, exceptional gold sales by the central bank, and the shortage of foreign exchange for private transactions that curtailed imports. Official reserves of Eritrea dropped below one month of imports of goods and services in 2002.

For 2003, the authorities prepared an "austerity" draft budget intended to reduce the domestic fiscal deficit (excluding all foreign-financed spending) to some 6 ½ percent of GDP, compared with 21 percent in 2002. On the revenue side, large increases were expected from the sales of government-owned houses and apartments, as well as the privatization of 3 hotels. On the expenditure side, the principal savings were planned to come from the demobilization of 130,000 combatants, which would have cut the defense budget in half. Because measures on both the revenue and expenditure side may be more difficult and time-consuming to implement than initially believed, the staff now projects a domestic fiscal deficit of 13 ½ percent of GDP.

Monetary policy has in recent years been dominated by the financing needs of the government's sizeable fiscal deficits. Money supply increased by 26 ½ percent in 2001 and 18 ½ percent in 2002, with credit to the government as the driving force.

Because of the precarious international reserves position and the virtual fixing of the official exchange rate, a dual exchange rate system has emerged in which the differential between the official and parallel market rates has risen markedly. Under the system, official transactions and other priority needs are being conducted in the official market, while the vast majority of private transactions, including bona fide current transactions, are being channeled through the parallel market. While the official rate has been kept largely unchanged at some ERN 14 per U.S. dollar since September 2001, the rate in the parallel market has lately moved up to between ERN 22 and ERN 24 per U.S. dollar.

In order to promote economic recovery and reduce poverty, the authorities hope to press ahead with a swift demobilization of combatants which would relieve the severe shortages of labor especially in the private sector, including agriculture. In addition, the authorities plan to continue their investment in human capital to raise labor productivity and improve competitiveness, and to further advance the rehabilitation and expansion of economic and social infrastructure. They are also strengthening prudential regulation and supervision to promote a sound and healthy financial sector. Other structural reforms that would increase economic growth include policies to reduce the role of government in commercial activities and strengthen private sector development. The government will be improving the dissemination of information on economic policies to increase transparency and facilitate the dialogue with the private sector.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They noted that macroeconomic conditions in Eritrea deteriorated in 2002—real GDP declined, inflation accelerated, and gross international reserves declined. In addition, the fiscal and external deficits remained unsustainably large. Directors acknowledged that these developments stemmed to a considerable extent from a serious drought, the legacy of war, political and governance difficulties, and limited human and financial resources. Nevertheless, they observed that there had been policy slippages as well, and stressed the need for urgent and decisive actions by the authorities to confront the enormous economic challenges facing Eritrea in the period ahead, including addressing the severe drought, accelerating the demobilization and re-integration of combatants, re-establishing macroeconomic stability, and laying the foundations for sustained economic growth and poverty reduction.

Against this background, Directors welcomed the important progress already made in some areas, including tax and expenditure reform, trade liberalization, and bank supervision. They called on the authorities to build on these efforts by formulating a comprehensive medium-term economic strategy. Such a strategy should be grounded in sound macroeconomic policies, properly prioritized and sequenced structural reforms, and a poverty reduction strategy formulated through a broad participatory approach. Directors recognized that external assistance will be critical for the success of the economic strategy, and encouraged the authorities to step up their efforts to resolve outstanding governance issues with donors to permit the resumption of such assistance. They urged the authorities to build the capacity needed for implementing a comprehensive reform program and supported the authorities' request for Fund technical assistance.

Directors welcomed the authorities' intention to substantially reduce the fiscal deficit in 2003, primarily through cuts in current spending, while shifting expenditures to education and health. While acknowledging that it will be difficult to achieve the deficit reduction, Directors urged the authorities to maintain the budget targets and to make best efforts to contain the domestic budget deficit at a level close to its initial target. This will require continued strengthening of expenditure control, improvement in revenue administration, and prompt promulgation of tax laws. Directors cautioned against lax public sector employment as a means of reducing unemployment among ex-combatants. Also, noting the rapid build-up of external public debt, Directors advised the authorities to develop a comprehensive debt strategy that relies mainly on concessional borrowing.

Directors observed that monetary and exchange rate policy had, over the past years, been entirely subordinated to the large financing needs of government. They called on the authorities to restore the effective independence of the central bank, and strengthen its transparency and accountability, so that it can concentrate on achieving the inflation and external balance objectives. They supported monetary tightening and a return to positive real interest rates. In addition, Directors urged the central bank to develop a coherent and transparent monetary policy framework that is better coordinated with fiscal policy, is supportive of the exchange rate regime to be put in place, and provides for a firm nominal anchor.

Directors expressed concern about the pervasiveness of exchange restrictions and distortions under the present dual exchange rate regime. They stressed the importance of unifying the official and parallel foreign exchange markets and introducing a single flexible exchange rate. The move toward such a regime should be supported by a phased removal of the existing exchange restrictions on current transactions.

While acknowledging that the government will continue to play an important role in the Eritrean economy, they urged the authorities to do a careful appraisal of that role and to adopt policies that foster the development of the private sector. They noted that dominance of publicly owned or managed enterprises could reduce competition and give rise to inefficiencies. They also called for the establishment of a sound and reliable legal and regulatory framework. Measures that could impede the expansion of the private sector, such as the recent official proclamations that tighten business licensing procedures and require the submission of business plans, should be reviewed.

Directors welcomed the strengthening of prudential regulation and supervision over the past two years. They noted that recent onsite inspections had revealed banking sector weaknesses, and urged that steps be taken to strengthen bank management and operations in line with best international practices. Directors also expressed concern about the high degree of concentration in the financial sector, and encouraged the authorities to consider steps to increase competition by actively promoting the entry of additional banks and privatizing dominant institutions. They welcomed the authorities' efforts to combat money laundering and terrorism financing.

Directors called for a broadening of the flow of information, an increase in transparency, and a strengthening of dialogue and cooperation mechanisms within government and between the government and the private sector. They urged the authorities to increase fiscal transparency through regular publication and open discussion of the budget, in order to encourage participatory policy formulation and increase accountability.

Directors noted the extensive weaknesses in statistics and urged the authorities to promulgate without delay a Statistical Act that was designed in order to strengthen statistical institutions and processes. They recommended regular publication of timely and reliable key statistics in the context of a strong and coherent reform agenda, supported by adequate financial and human resources. This would be crucial, inter alia, to permit proper assessment of the authorities' track record of policy implementation.

Directors welcomed the renewed interest of the authorities in a Fund-supported economic program. They encouraged the authorities to establish a solid track record of policy implementation under a staff-monitored program, with a view to establishing quickly—in collaboration with Fund staff—conditions permitting the negotiation of an arrangement under the Poverty Reduction and Growth Facility, and to advance speedily with the drafting of an Interim Poverty Reduction Strategy Paper.

It is expected that the next Article IV consultation with Eritrea will be held on the standard 12-month cycle.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Eritrea is also available.

Table 1. Eritrea: Selected Economic and Financial Indicators, 1996-2003

	1996	1997	1998	1999	2000	2001 Prel.	2002 Prel.	2003 Proj.
	(Annual percentage change, unless otherwise specified)							
National income and prices								
GDP at constant factor prices	9.2	7.7	3.9	0.3	-12.0	8.7	-1.2	5.4
Consumer prices (end of period)	...	7.7	9.0	10.6	26.8	7.7	23.8	14.0
Food	...	7.9	20.3	12.9	31.5	5.2	17.9	14.0
Non-Food	...	7.6	-0.7	8.2	21.8	10.7	30.4	14.0
External trade								
Exports, f.o.b. (in U.S. dollars)	18.2	-43.8	-47.3	-28.6	82.6	-45.7	160.0	-32.2
Imports, c.i.f. (in U.S. dollars)	27.2	-3.7	6.5	-6.1	-4.9	14.1	-0.6	7.7
Money and credit (end of period)								
Broad money (including foreign currency deposits) 1/	18.7	30.6	18.2	40.9	13.0	26.4	18.5	26.6
Velocity (GDP/average broad money)	1.3	1.22	1.08	0.88	0.76	0.79	0.73	0.73
Interest rate (savings deposits; in percent)	6.0	6.0	6.0	6.0	6.0	6.0	5.0	...
	(In percent of GDP, unless otherwise specified)							
Central government operations								
Total revenue	31.2	40.7	30.5	31.7	34.0	25.6	25.4	25.8
Total expenditure	56.7	51.4	76.3	91.4	66.7	58.5	57.3	50.1
Of which: defense	21.1	12.7	35.0	37.2	35.8	24.2	23.3	18.1
Overall fiscal balance (excluding grants)	-30.1	-11.4	-47.4	-62.1	-51.5	-52.5	-42.5	-43.7
Overall fiscal balance (including grants)	-19.4	-5.6	-38.0	-53.9	-32.1	-34.8	-30.1	-24.4
Domestic fiscal balance 2/	-17.8	-1.5	-30.2	-41.3	-25.5	-21.6	-20.8	-13.6
Financing	18.0	8.1	37.2	53.2	32.5	32.3	30.4	24.4
External	1.2	4.1	3.7	8.7	8.6	13.5	10.2	6.9
Domestic	16.8	4.0	33.5	44.5	23.9	18.8	20.2	17.4
Central government domestic debt (net)	31.7	30.5	58.2	96.7	125.9	119.9	123.2	116.6
External sector								
Current external balance (excluding official transfers)	-19.5	-5.4	-31.5	-38.4	-32.0	-35.4	-27.8	-29.3
Current external balance (including official transfers)	-7.3	2.1	-23.6	-27.9	-16.2	-18.4	-15.4	-10.4
External public debt 3/	6.7	11.0	18.8	37.5	51.4	60.8	78.6	76.4
Debt service/exports (in percent) 4/	0.0	0.3	0.8	5.7	3.8	5.3	15.1	12.9
	(In millions of U.S. dollars, unless otherwise specified)							
Overall balance of payments	53.5	146.7	-174.1	-14.7	-15.2	7.2	-39.0	1.5
Gross international reserves	126.2	243.3	69.0	54.3	36.6	50.6	33.1	30.5
(in months of imports of goods and services)	2.7	5.0	1.4	1.1	0.9	1.1	0.7	0.6

Sources: Eritrean authorities; and staff estimates and projections.

1/ Figure before 1997 excludes currency outside banks in Eritrea.

2/ Total revenue less expenditures excluding, external interest, humanitarian assistance, ERP, demobilization, and other externally financed outlays.

3/ Public and publicly guaranteed debt, including projected new debt.

4/ Three-year average of exports of goods and services used.

Statement by Ismaila Usman, Executive Director for Eritrea
May 2, 2003

Key Messages

- Eritrea, a post-conflict country in transition faces numerous economic and political challenges.

- Eritrea is currently facing the worst drought in its history. Thanks to the ongoing efforts by the international community including multilateral institutions and bilateral donors towards addressing the problem as well as towards facilitating the demobilization and reintegration process of combatants, to help establish lasting peace.

- Assistance, thus far, however, has fallen short of meeting the immediate needs associated with the drought. Similarly, the demobilization and reintegration process is being delayed in part due to inadequacy of financial resources.

- The role of the international community is critical in providing the impetus to steer Eritrea beyond the post-conflict phase and transitional process toward poverty reduction and sustainable growth in both the short-term and over the medium term.

- In this connection technical assistance (TA) is another important and critical component to help address institutional, human, legal and other capacity constraints facing the country.

Introduction

The country has experienced the worst drought since 1993, and continues to suffer from extensive destruction of infrastructure and widespread dislocation of large sections of the population resulting from the border conflict with Ethiopia during 1998-2000. Despite the above, progress is being made in stabilizing and reconstructing the economy, reducing the size of government and its involvement in the economy, especially in the banking sector, where more competition is gradually making foreign exchange transactions market determined. Efforts have been made to restore relations with donors to facilitate commencement of an economic program that could be supported by the Fund. The implementation of a tax reform package in October 2001 fell short of understandings reached with staff, however, the authorities have expressed renewed interest in resuming discussions on an economic program that could be supported by the Fund.

2. Recent Macroeconomic developments

Eritrea's macroeconomic performance has faced severe imbalances as well as a prolonged suspension of budgetary and balance of payments assistance from donors, because of concerns about political governance. The suspension of critical donor assistance has also impaired reconstruction efforts. The border conflict with Ethiopia has led to a slow implementation of the demobilization program, thereby impacting adversely on economic recovery and development. The drought negatively affected economic growth resulting in rising inflation in 2002, with real GDP falling to 1.2 percent. Delays in demobilization and the demining of agricultural land also led to a fall in crop production to about 77 percent. Strong activity in the construction and trade sectors however led to an increase in nonagricultural growth by over 6 percent. Supported by the large depreciation of the local currency and strong growth in monetary aggregates, food prices increased by 18 percent, reflecting a growing shortage of food. Non food inflation on the other hand, increased by more than 30 percent.

a. Fiscal developments

Notwithstanding the adverse impact of the drought, progress was made in some areas. Fiscal policy in 2002 was less expansionary, although a large increase in domestic financing was required to cover the government deficit. As a result of the large expansion of capital expenditures to reconstruct the economy, the overall deficit, including grants, amounted to 30 percent of GDP, as compared to 35 percent in 2001. This however, reflected a sharp reduction in capital spending that was necessary due to lower external financing. The fiscal deficit remained unchanged at 21 percent reflecting the impact on domestic resources. Specifically, revenue performance improved on account of tax system reforms and enhancements in tax administration, while some progress was also made on public expenditure management. Delays in demobilization and a doubling in allowances for combatants and people in the National Service led to an increase in current expenditure by about 7.25 percent of GDP.

b. Monetary and Exchange Rate developments

Broad money grew by 18.5 percent, due to strong expansion of credit to the government, Interest rates however remained stable in nominal terms, but real interest rates turned negative as inflation increased. The easing of monetary conditions at the end of 2002, by reducing reserve requirements also did not help matters. In this connection, my authorities agreed with staff on the need to tighten up and to curb inflation and restore interest rates to positive levels. As staff rightly observed, progress in these areas will require that Fund TA be obtained to enhance institutional and human capacity building. The authorities look forward to the Fund's response in this regard.

In 2002 the external current account deficit remained at an unsustainable level resulting in low level of official reserves. This led to a sale of gold by the BE in the open market, amounting to US$10.3 million, or 1.6 percent of GDP to mitigate the situation. The precarious international reserves position and the virtual fixing of the official exchange rate, caused the differential between the parallel market and the official rate to widen markedly. While my authorities agree with staff on the need to reform the exchange system, without a significant improvement in the foreign reserves situation it would be difficult to achieve an early unification of the rates. They remain committed however to doing everything possible to accelerate the process. In this connection also they intend to request for Fund TA as recommended by staff to develop operational modalities.

c. Structural Reforms Undertaken

On structural reforms, my authorities have taken numerous positive steps including by introducing reforms to customs and reducing effective import tariff rates considerably. As a result, the trade restrictive index dropped from a rating of 6 to 4 and the average tariff rate declined from 18.5 percent to 9 percent. In addition, the top tariff rate was reduced from 200 percent to 25 percent, and the number of bands from 12 to 3. These measures along with others have rendered Eritrea's trade regime among the most liberal in Africa. My authorities' are committed to deepening structural and institutional reforms in order to enhance the responsiveness of the economy

On banking sector reform, the first on-site inspection of the loan portfolios of the three domestic banks were conducted in 2002, by the Bank of Eritrea. The inspections revealed several problems with the management and administration of banks. The banks have been instructed to develop action plans to implement the recommendations of the inspection reports. External audits of the banks are ongoing, to be followed by full fledged on-site inspections. Also, as an interim measure, additional efforts are being made to strengthen the data reporting system for effective off-site surveillance of banks.

3. Policies for 2003

My authorities are aware of the seriousness of the macroeconomic imbalances facing the country, and therefore have no fundamental disagreement with the recommendations made by staff. The year 2003 is regarded as a period of transition, during which my authorities intend to provide clear signals about their commitment to macroeconomic stability and to lay the foundation for a more normal conduct of macroeconomic and development policies. It need however be recognized that the lack of donor financing would lead to a continuation of balance of payments pressures and hamper growth and development because of continued shortages of foreign exchange. My authorities urge the Fund to facilitate an early re-engagement of donor assistance to be complemented by Fund resources and TA to help them to address the challenges facing the economy.

a. Fiscal Policy

My authorities fully agree that the deficit level over the past four years is not sustainable, and they are committed to reducing it to manageable levels, and they urge that their efforts be complimented with financing and grants from donors and multilateral institutions including the Fund. In the 2003 austerity budget the authorities hope to reduce expenditure from levels close to 40 percent of GDP in 2001 and 2002 to 22 percent of GDP in 2003. Defense spending would be cut by half, as a result of the planned implementation of the demobilization program that would release some 130,000 combatants in 2003. Also, foreign funding for capital expenditures is assured.

In 2003 the planned sale of government owned houses and the privatization of some hotels is expected to boost revenue when budget deficit is projected to drop from about 21 percent of GDP in 2002 to 6.5 percent of GDP in 2003, while the overall deficit, including grants, would be reduced from 30 percent of GDP in 2002 to about 24 percent of GDP in 2003.

b. Monetary and Financial Sector Policies

Monetary policy is aimed at reducing the fiscal deficit and curtailing its bank financing. To avoid distortions in financial intermediation, interest rates on bank lending will be restored at positive levels. To ensure better monetary management, the BE will develop a coherent and transparent monetary policy framework as well as a clear strategy for the rational use of its policy instruments with well defined objectives. However, my authorities will continue to request technical assistance support from the Fund to build capacity and institutional development on which such progress depends

To achieve more competition in the financial sector, my authorities would encourage the entry of new banks, including fully foreign-owned banks. More effort will be made towards the establishment and strengthening of the supervision framework to enforce banks' compliance with key prudential ratios, increase the transparency and accountability of their operations, and ensure the adoption of international accounting practices.

4. Medium Term Outlook

Public sector domestic debt is expected to increase, reaching 131 percent of GDP in 2008. In line with the drawdown of existing loan commitments, the level of external debt as a percent of GDP will rise over the period 2003-05 to almost 90 percent of GDP, but would decline thereafter, to about 85 percent of GDP by 2008. The NPV of both external debt and external debt service, as a percent of exports of goods and services, will also increase initially and then begin to drop by the end of the projection period. The implementation of the demobilization program will release 130,000 combatants by end-2003, and the residual 70,000 by end-2004. This will lead to an increase in labor supply to the productive sectors of the economy and raise donor funding for demobilization. Political governance issues are being seriously addressed to enable donors resume their budgetary and balance of payments assistance. Also, the authorities intend, with resumed donor financing and therefore improved foreign exchange inflows, supported by appropriate reforms and stability in macroeconomic policies, to achieve unification of the current dual exchange rate.

The combination of improved macroeconomic performance and higher donor financing will significantly strengthen the sustainability of the public finances. The domestic fiscal deficit will drop to about 5.5 percent of GDP by 2008, compared with more than 15 percent under the baseline scenario. Over the period 2003-08, the overall fiscal deficit will decline by about 16 percentage points to 8 percent of GDP.

5. Technical Assistance and Capacity Building

The implementation of the authorities' poverty reduction program, consolidation of macroeconomic measures and the deepening of the related structural reforms will certainly exert pressure on the country's limited administrative, institutional and technical capacity. My authorities wish to acknowledge the technical assistance extended to the government thus far and to stress the need for continuation of the assistance in different areas with a view to building and strengthening local capacity given the limited domestic resources.

My authorities have expressed a renewed interest in a Fund-supported program, specifically a Poverty Reduction and Growth Facility (PRGF). To this end, they have already started preparing an interim Poverty Reduction Strategy Paper (I-PRSP), and it is hoped that a first draft will be available by mid-June 2003. The authorities are determined to continue with adjustment and reforms and to establish the necessary track record required under a Staff Monitored Program (SMP). They have requested, in this connection, that a mission return to Eritrea in mid-2003 to discuss the SMP.

6. Conclusion

In conclusion, I urge the Board to recognize the difficult economic circumstances and the formidable challenges facing Eritrea and to facilitate paving the way to peace and stability, being necessary conditions for economic growth and poverty reduction in Eritrea. The task ahead is challenging and daunting, however, the authorities are determined to forge ahead in order to consolidate peace and to ensure security throughout the country, enhance growth and improve the quality of life for the poor. There are no easy and quick fix solutions but an early restoration of donor assistance to Eritrea will go a long way in putting Eritrea back on the path of reconstruction, recovery and growth.