Economic Snapshot H2, 2016

Ethiopia

Inflation – Inflationary pressures have generally eased in 2016. After nearly reaching 12% y-o-y in Q3 2015, consumer price inflation has trended lower this year, with the most recent figure showing a 6% y-o-y increase in the consumer price index (CPI) in July. Food price inflation dropped from 7.2% y-o-y in June to 4.1% y-o-y in July, while non-food price inflation increased from 7.8% y-o-y to 8.3% y-o-y over the same period. Furthermore, the CPI rose by 0.5% on a m-o-m basis in July compared with a 1% m-o-m increase the previous month.

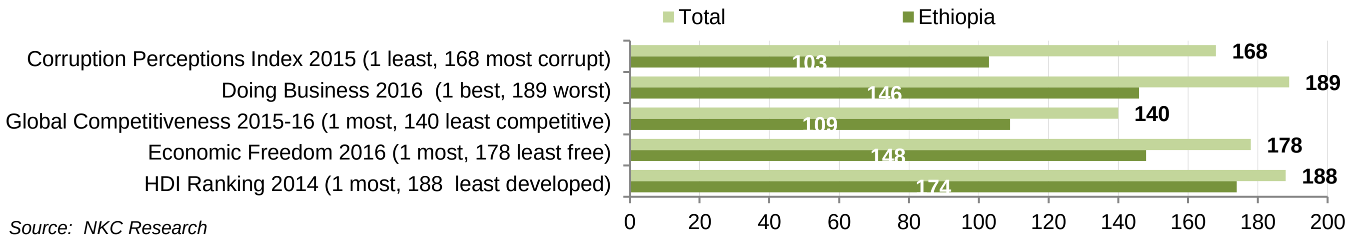
Growth – While Ethiopia remains one of the world's fastest growing economies, the recent drought and subsequent floods will have a notable impact on GDP growth this year. After reaching 8.3% in 2015, real GDP growth is projected to ease to 6.7% this year. However, the country's abundance of natural resources, favourable demographics and ambitious public infrastructure investment programmes will continue to support growth going forward. Ethiopia is expected to remain on an elevated development trajectory.

National development plan – Ethiopia's economic policy is guided by the second phase of the Growth and Transformation Plan (GTP2, 2015/16 - 2020/21). The most prominent objectives outlined in the GTP2 include the country's plans to become the centre of a regional energy-trade network, as well as becoming a global manufacturing hub. Overall, the ultimate goal is to push Ethiopia into middle-income status by 2025.

OPPORTUNITIES	STRENGTHS
Developing the renewable energy sector, which would diversify exports and supply stable electricity to Ethiopia, thereby supporting growth.	Very high economic growth rates recorded in recent years.
Immense area of land available for commercial agriculture, which is currently dominated by smallholder farming.	Substantial natural resources and favourable demographics ensure that strong prospects for economic growth will continue.
Development of the manufacturing sector, particularly by making use of designated Special Economic Zones.	Increasing interest from India, Saudi Arabia and China in developing the economy.
Integrating Ethiopia into the neighbouring East African Community (EAC).	Strong donor support enables the country to access additional resources, enabling capital investment and faster economic development.

VULNERABILITIES	WHAT IS BEING DONE?
Economic structure shows a heavy reliance on the agricultural sector, with production skewed towards smallholder farming.	Development of the agro-processing and leather industries, promotion of commercial farming enterprises.
Country has a structural budget deficit, resulting in heavy dependence on donor aid.	Government is focusing on increasing tax revenue to fund fiscal expansion, but still relies on donor aid for around 20% of fiscal revenue.
Repressive economic policy towards investors – foreign investment prohibited in banking, insurance and media sectors, and limited in others.	Increasingly allowing privatisation of public enterprises, which may indicate future relaxation of restrictive policies.
Increasing debt levels due to GTP financing.	While borrowed funds are being used for productive investments, off-budget financing distorts analysis of actual debt levels.

MEGA TRENDS	
Population	99,465,819 (July 2015 est.); Age 15 - 64: 53.2%
Population growth rate (%)	2.9% (2015 est.)
Life expectancy at birth	Total population: 61.5 years; male: 59.1 years; female: 63.9 years (2015 est.)
HIV/AIDS	Adult prevalence rate: 1.2%; People living with HIV/AIDS: 730,317 (2014 est.)
Adult literacy rate (age 15 and over, can read and write)	Total population: 49.1%; male: 57.3%; female: 41% (2015 est.)
Urbanisation	Urban population: 19.5% of total population (2015); Urban population growth: 4.8% (2015)
Population below national poverty line	39% (2012 est.)
Unemployment rate	17.4% (2014 est.)
Employment (% of total)	Agriculture: 72.7%; Industry: 7.4%; Services: 19.9% (2013 est.)
Labour participation rate (% of total population ages 15+)	83.7% (2014)
Business languages	Amharic, Arabic, English
Telephone & Internet users	Main lines in use: 890,642; Mobile cellular: 42.3 million; Internet users: 11.5 million (2015)
Sources: CIA World Factbook, World Bank, Trading Economics, UNESCO, ITU, UNAIDS & NKC Research	



Source: NKC Research

Risk environment / Risk outlook

Sovereign Risk Ratings		
S&P Global Ratings	**Fitch**	**Moody's**
B/Stable	B/Stable	B1/Stable

S&P Global Ratings (S&P) affirmed Ethiopia's sovereign credit rating at "B" with a stable outlook in April this year. According to the agency, Ethiopia's credit rating is constrained by generally low income levels, a weak external position and limited monetary policy flexibility, while the primary factor supporting the rating is the East African nation's positive economic growth outlook. With regard to the latter, S&P noted that Ethiopia's growth had outstripped that of regional peers in recent years and prospects remain positive. In turn, **Fitch Ratings** affirmed Ethiopia's sovereign risk rating at "B" in April this year, maintaining the outlook on the ratings at stable. According to the agency, Ethiopia's poor development and governance indicators illustrate weak debt tolerance, entrenching the country's rating in the "B" category. In addition, the country performs poorly relative to similarly-rated peers in indicators relating to per capita income, and human & financial development. Furthermore, structurally high and volatile inflation remains a concern, while external vulnerabilities are increasing as reflected in precariously-wide current account deficits. That being said, the agency noted that the sharp decline in international oil prices has helped mitigate the impact of the drought on fiscal balances, and the country continues to benefit from international donor support. According to Fitch, macroeconomic spillovers related to the drought have remained contained relative to previous drought episodes, while traditional export commodities have not been severely affected. Furthermore, **Moody's Investors Service** assigned Ethiopia a first-time sovereign credit rating of "B1" with a stable outlook in early May 2014. More recently, in a market update at the end of May last year, the agency noted that Ethiopia's credit rating is supported by the country's strong growth prospects, prudent fiscal management and large and stable donor inflows. In turn, the country's credit rating is constrained by Ethiopia's relatively small economy, low per capita income, and weak institutional strength. The agency noted that it expects public sector investment to continue to drive economic expansion in the near term, with real GDP growth averaging around 10% p.a. over the next two years. However, the agency emphasised that risks to this outlook stem from external shocks, such as an economic slowdown in major export partners, constraints to the financing of Ethiopia's investment projects, or a protracted slump in commodity export prices.

Infrastruc-ture	Diversity of the Economy	Banking Sector	Continuity of Economic Policy	GDP Growth	Key Balances	Foreign Investment	Socio-economic Develop-ment	Forex Reserves
Fairly limited, but improving	Dominated by agriculture	Under-developed	Stable, but poor	Strong	Fiscal and current account deficits	Fair, but below potential	Low	Low

Stock Market	Listed Companies	Liquidity	Market Cap	Dominant Sector	Daily Trading Volume
N/A	N/A	N/A	N/A	N/A	N/A
Capital Market	**Development**	**Liquidity**	**Maturity Range**	**Municipal Bonds**	**Corporate Bonds**
Yes	Underdeveloped	Limited	28-days to 364-days (T-bill)	No	Yes

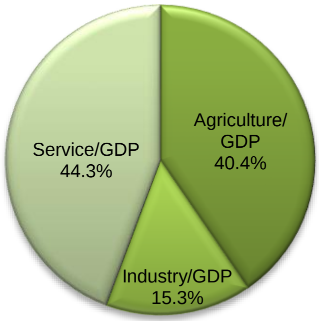
Macro-economic overview

Ethiopia continues to make steady progress on the economic front, with a track-record of strong real GDP growth reflected in improving infrastructure and a reduction in poverty. However, the strong headline growth figures mask some salient economic vulnerabilities. These vulnerabilities pertain to the country's weak external liquidity position and susceptibility to exogenous shocks. The former is exacerbated by the National Bank of Ethiopia's (NBE) resolve to manage the birr exchange rate through forex market intervention, which weighs on the country's ability to accumulate foreign currency while keeping the birr artificially strong. Inadequate foreign currency reserves directly affect the country's ability to honour external liabilities, and thus have a direct impact on Ethiopia's sovereign credit rating. In addition, the country is vulnerable to numerous exogenous shocks, including adverse weather conditions disrupting domestic food production and reducing export receipts, and the suspension of donor support which could lead to fiscal unsustainability. The recent drought has illustrated the country's vulnerability to adverse weather conditions, and the subsequent rise in donor funding has shown how dependent the country is on external grants.

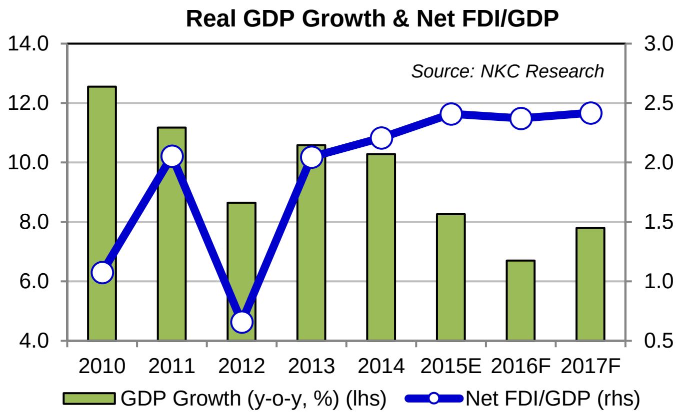
Despite these vulnerabilities, Ethiopia's economic growth outlook remains positive. The drivers that have supported Ethiopia's commendable growth in recent years remain in place, and while the recent drought will have a negative impact on Ethiopia's macroeconomic environment, these effects are considered transient and should dissipate over the medium term. Improving macroeconomic fundamentals such as a higher level of foreign currency reserves, enhancing transparency with regard to fiscal finances, and diversifying the exports base will go a long way in improving the country's economic resilience.

Economic Structure as % of GDP
2015 Estimate

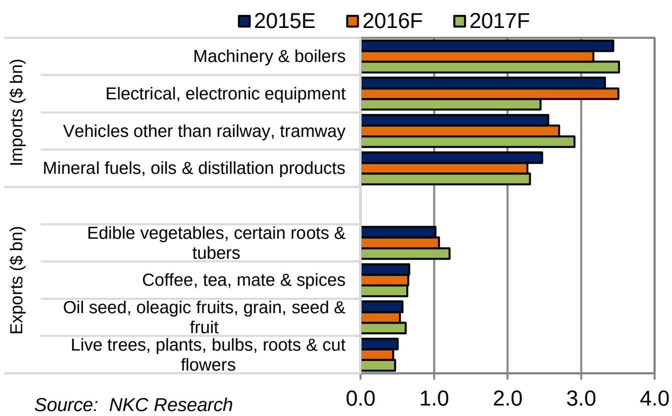
Source: NKC Research



The Ethiopian economy remains highly dependent on its agricultural sector, with roughly half of the rural population directly engaged in agriculture as an economic activity. The sector is also a significant contributor to overall economic production, accounting for over 40% of GDP last year. The agricultural sector, in turn, is dominated by crop production, accounting for around 70% of agricultural production, followed by animal husbandry (20%) and forestry (10%). The industrial sector, in turn, is driven by public infrastructure investment as the government seeks to establish Ethiopia as a regional electricity exporter and manufacturing centre. The industrial sector accounts for less than 15% of GDP, but will be the primary channel through which structural transformation will be driven in Ethiopia. Furthermore, the services sector has recently overtaken agriculture to become the largest contributor to overall GDP in the Ethiopian economy. The largest services sub-sector is wholesale & retail trade, while other notable services sectors include real estate, hotels & restaurants, and transport & communication.



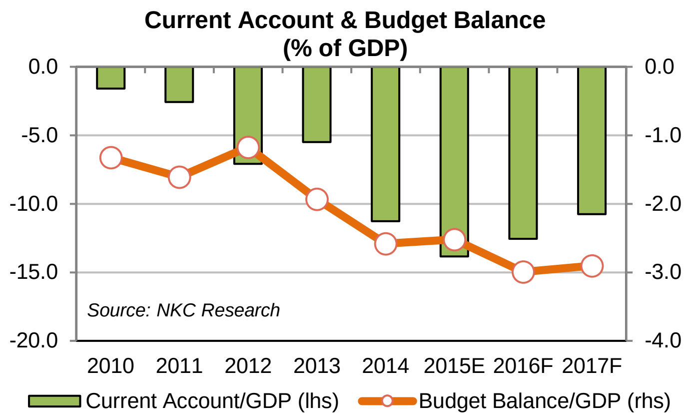
The recent drought and subsequent floods have had a devastating impact on the country's agricultural sector, which will have considerable spillover effects into other sectors such as services and manufacturing – due to the impact on income levels and agro-processing inputs. In addition, the country's dependence on hydro-energy is reflected in a marked reduction in generation capacity due to the drought, which will have adverse effects on the industrial sector more generally. These factors are expected to put negative pressure on Ethiopia's economic performance this year, with real GDP growth dropping from 8.3% in 2015 to 6.7% this year. However, the drivers that have supported Ethiopia's commendable growth in recent years remain in place, and while the recent drought will have a negative impact on Ethiopia's macroeconomic environment, these effects are considered transient and should dissipate over the medium term. Turning to foreign investment, despite severe restrictions on foreign participation in the economy, Ethiopia continues to attract foreign interest due to the country's positive growth prospects. The country has received large greenfield investments from China, India, Turkey, Pakistan and the Republic of Korea. Most recently, DBL Group, Bangladesh-based apparel manufacturer, announced that it will construct a $100m textile factory in the country, while Japan Tobacco has acquired a 40% ($510m) stake in Ethiopia's monopoly tobacco company, the National Tobacco Enterprise.



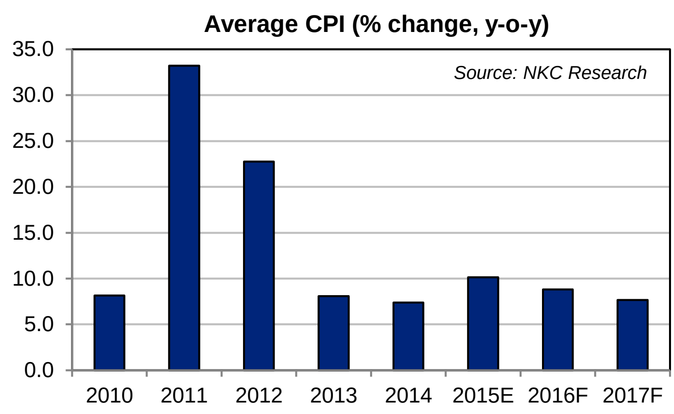
Source: NKC Research

Main Imports: % share of total	2015E	2016F	2017F
Machinery & boilers	20.58	17.82	20.06
Electrical, electronic equipment	19.90	19.75	13.98
Vehicles other than railway, tramway	15.28	15.20	16.61
Mineral fuels, oils & distillation products	14.78	12.77	13.14
Main Exports: % share of total	**2015E**	**2016F**	**2017F**
Edible vegetables, certain roots & tubers	34.93	33.95	34.32
Coffee, tea, mate & spices	22.72	20.54	18.07
Oil seed, oleagic fruits, grain, seed & fruit	19.49	16.98	17.43
Live trees, plants, bulbs, roots & cut flowers	17.38	14.10	13.36

Total exports amounted to $765m during the first quarter of this year, reflecting a 6.8% y-o-y decline. This decline was largely driven by lower gold (-42.5% y-o-y to reach $67m) and leather (-22.2% y-o-y to reach $28m) exports. Coffee exports also disappointed during the quarter, decreasing by 4.2% y-o-y to reach $163m. These weak performances were counterweighed by a remarkable 15.2% y-o-y increase in oilseed exports, with the latter reaching just over $200m during the quarter. In turn, total imports amounted to $4.4bn during the quarter, reflecting a 4.1% y-o-y increase. Capital goods imports dropped by 9.3% y-o-y during the quarter, reaching $1.7bn, while consumer goods imports rose by a significant 25.2% y-o-y in Q1 to reach $1.5bn. Overall, this resulted in a merchandise trade deficit of around $3.6bn, which is 6.8% y-o-y wider than the deficit recorded in Q1 2015.



The Ethiopian Parliament approved the budget for the 2016/17 fiscal year (FY, July to June) in early July. The unanimously-endorsed budget projects a 13.7% increase in total expenditure, with public spending reaching around $12.6bn during the year. The latest budget maintains a focus on capital spending, with some 38% of the total budget directed towards development projects. In turn, around 25% of the budget will go towards recurrent spending, while 32% will be transferred to regional states. In reference to the recent drought that afflicted large parts of the country, the Ethiopian prime minister recently noted that the government has so far directed around $800m towards relief efforts. However, from a budgetary perspective, the effects of the drought could be contained due to international donors covering a large part of the drought relief bill through grants and direct assistance to the affected populations. From a revenue perspective, the primary economic effect of extreme weather falls on non-taxed subsistence farming, and is expected to have a limited impact on revenue generation. After reaching an estimated 3% of GDP in the 2015/16 fiscal year, Ethiopia's fiscal deficit is expected to narrow slightly to 2.9% of GDP in the current fiscal year. This is due to our assumption that most of the domestically-funded drought relief efforts have already taken place. Turning to external balances, Ethiopia recorded a current account deficit of $2.1bn during the first quarter of the year, reflecting a slight 1% y-o-y widening. The wider merchandise trade deficit was accompanied by a near quadrupling of the services deficit (reaching $280m). However, these developments were largely offset by a 30.4% y-o-y increase in the current transfers surplus, reaching $1.8bn, while the income account continued to play a marginal role in the economy.



Consumer price inflation averaged 8.2% y-o-y in H1 2016, which is notably lower than the 2015 H2 average of 11.2% y-o-y. Elevated price inflation in the latter half of last year was primarily due to the food sub-index, which recorded an average increase of 14.1% y-o-y during the period. Price inflation remains elevated in Ethiopia, with base-effects the most likely reason why inflation readings have dropped below double-digit territory. Drought conditions have devastated food production, which has resulted in a humanitarian crisis. More recently, the drought has been followed by flash floods, with the latter exacerbating food insecurity. Ethiopian monetary authorities are unable to contain inflationary pressure due to the exogenous nature of the food price shock, as well as the undeveloped monetary framework in which the central bank operates. One channel through which the central bank has been able to limit inflationary pressure is through the birr exchange rate, which the National Bank of Ethiopia (NBE) has kept artificially stable for numerous quarters. This contains imported inflation while also deteriorating external competitiveness. Looking ahead, annual inflation is expected to ease slightly from an average of 10.1% in 2015 to 8.8% this year, but this will largely be due to base effects, with consumers remaining under pressure due to elevated prices.

CONTACT DETAILS	
KPMG	**NKC**
Josphat Mwaura – designation is Chief Executive Officer/Senior Partner Tel +254 20 280 6100 Email jmwaura@kpmg.co.ke	NKC AFRICAN ECONOMICS AN OXFORD ECONOMICS COMPANY 12 Cecilia Street Paarl, 7646, South Africa P O Box 3020, Paarl, 7620 Tel: +27(0)21 863-6200 Email: research@nkc.co.za