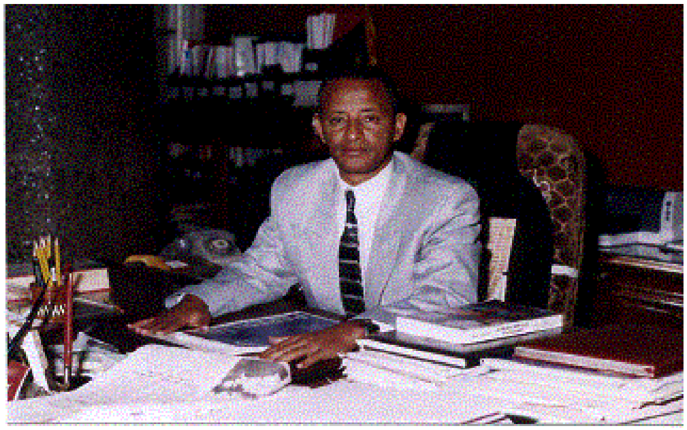
Governor's Note



I am pleased to present, on behalf of the Board of Directors, the 2005/06 Annual Report of the National Bank of Ethiopia. The Annual Report reviews the latest developments witnessed in the Ethiopian economy. It covers major areas of the economy including, among others, the real sector, prices, monetary, external and financial sector developments, as well as general government fiscal operations.

With regard to the performance of the economy, the Ethiopian economy witnessed a remarkable growth rate of 9.6 percent as a continuation of the commendable growth attained in the last two successive years, i.e 10.5 and 11.9 percent in 2004/05 and 2003/04, respectively which is a reflection of the sound economic policy and favorable weather conditions. This remarkable performance puts Ethiopia along with the fast growing economies in SSA countries. Agriculture and allied activities continued to contribute their lion's share to the 9.6 percent real GDP growth followed by services and industry.

Government fiscal operations have also remained as envisaged, with government revenue improving and poverty related and developmental expenditures increasing. Accordingly, general government revenue, including grants, showed a 15.3 percent increase to Birr 23.2 billion while a total of Birr 29.3 billion was spent on different government activities, 18.2 percent higher than that of last fiscal year. Thus, owing to higher government budgetary expenditures over revenue, the overall fiscal deficit (including grants) widened to Birr 4.66 billion whose GDP ratio reached 5.3 percent during the review period. Hence, the fiscal stance of the government was broadly consistent with the aim of maintaining macroeconomic stability and reducing poverty and at the same time achieving MDGs.

The monetary policy, as usual, continued to focus on maintaining price and exchange rate stability and creating a conducive environment for accelerated economic growth during the review period. Within this broad spectrum, broad money supply growth of 15.3 percent was achieved in 2005/06 which was broadly consistent with the nominal GDP growth rate of 16.1 percent. The observed monetary growth was largely driven by expansion in domestic credit, which in turn was driven by growing aggregate demand. As the economy expanded, both headline and underlying inflation also tended to crawl up with the former reaching 12.3 percent compared to 6.8 percent and the latter rising to 8 percent from 5.2 percent a year ago. The major underlying factors for the rise in the inflation rates were increases in food prices, despite a good harvest, and higher prices of fuel and construction materials, and others. After seriously considering the existing economic fundamentals and weighing the costs and benefits of the policy measure, the National Bank of Ethiopia opted for not changing the interest rate as a monetary policy instrument to contain inflation and to make the real rate of interest positive. However, inflationary pressure remains one of the concerns of the country's monetary policy.

The exchange rate of the Birr continued to be determined in the daily inter-bank market with the NBE intervening in the market as necessary. Hence, the Birr has been allowed to steadily depreciate in terms of USD and its period average exchange rate stood at Birr 8.68/USD, with annual nominal depreciation rate of 0.34 percent. In addition, despite 2.6 percent depreciation in the nominal effective exchange rate, the real effective exchange rate of the Birr has appreciated by about 8 percent in 2005/06 owing to relative increase in domestic inflation vis-à-vis that of Ethiopia's major trading partners. Cognizant of this fact, the NBE is keen to take appropriate measures at its disposal which would help maintain the country's external competitiveness.

As for the external sector, exports registered a robust growth in 2005/06, as earning from exports reached a record high of USD 1000.3 million, up by 18 percent compared to USD 847.2 million in 2004/05. The strong upsurge in export earnings was achieved from improvement in earnings from all export items, except chat and fruits and vegetables, as prices of most of these commodities tended to improve in the world market. Meanwhile, total imports also revealed substantial growth to reach USD 4383.4 million in 2005/06 from USD 3633.3 million in 2004/05, with capital goods along with raw materials, semi finished goods and fuel alone accounting for 68.6 percent of total imports during the review fiscal year. As a result, the country's trade and current account deficits widened and the overall balance of payments also moved into deficit as a reflection of a slowdown in net foreign assets in 2005/06. Yet, the country's international reserves was sufficient to cover 2.3 months of imports of goods and services of next fiscal year.

Regarding the developments in the financial sector all financial institutions have continued to improve their operations in terms of branch expansion and operational results. Although the number of banks and insurance companies operating in the country remained at the previous year level of ten and nine, there has been a significant increase in their branch networks reaching 421 and 138 respectively in 2005/06. Hence, the ratio of bank branch to population is estimated to have reached 1:178,000, which was still quite unfavorable even by a developing country standard. At the same time, banks have continued to expand their operations. They increased their resource mobilization through deposits and loan collection. They also disbursed 31.5 percent more loans to different sectors of the economy particularly to the private sector during the review year. They made good progress in reducing their NPLs (non-performing loans) and obtaining substantial profit. Yet, excess reserves in the banking system continued to pose a challenge to monetary policy despite NBE's efforts to reduce it through sale of T-bills and other available means. MFIs are also becoming significant players in the financial sector not only in terms of their growing number (26 in 2005/06) but also through their services rendered to low-income groups and their contribution towards poverty reduction strategies of the government.

All in all, despite the inflationary pressure and widening trade and current account deficits the review year was largely characterized by encouraging overall economic performance, prudent fiscal and monetary stance and sound financial sector development. This scenario calls for all stakeholders including the government, development partners and the public at large to reinvigorate and revitalize their efforts and contribution towards achieving the Millennium Development Goals and making poverty a history in Ethiopia in the coming 20-30 years.

Finally, I would like to seize this opportunity to thank those government institutions and all the staff and management of the NBE for their cooperation and dedication in helping achieve the primary and secondary objectives of the NBE as set in its 2005/06 action plan and I hope they would continue to do so in the future.