INTERNATIONAL DEVELOPMENTS

9.1 International Economic Developments

9.1.1 Overview of World Economy

Year 2006 witnessed robust global economic growth. World economy is estimated to grow by 5.1 percent in 2006 from a moderate growth of 4.9 percent in 2005. This reflects the continuous expansion of global economy above-trend growth for three consecutive years. Growth tends to become more balanced in 2006 with growth in the United States slowing and the Euro area picking up, while Japan's growth is moderating toward trend. At the same time, emerging markets and developing countries registered an extra-ordinary growth performance of 7.3 percent in 2006(World Economic Outlook, September, 2006).

Table 9.1: Overview of the World Economic Outlook and Projections

(Annual Percentage Changes)

	2004	2005	Projection	
			2006	2007
World Output	**5.3**	**4.9**	**5.1**	**4.9**
Advanced Economies	3.2	2.6	3.1	2.7
United States	3.9	3.2	3.4	2.9
Euro Area	2.1	1.3	2.4	2.0
Japan	2.3	2.6	2.7	2.1
Other Emerging Markets and Developing Countries	7.7	7.4	7.3	7.2
World Trade Volume (goods & services)	**10.6**	**7.4**	**8.9**	**7.6**
Imports				
Advanced Economies	9.1	6.0	7.5	6.0
Other Emerging Markets & Developing Countries	16.4	11.9	13.0	12.1
Exports				
Advanced Economies	8.8	5.5	8.0	6.0
Other Emerging Markets & Developing Countries	14.6	11.8	10.7	10.6
Commodity Prices				
Oil	30.7	41.3	29.7	9.1

Non-oil	18.5	10.3	22.1	-4.8
Consumer Prices				
Advanced Economies	2.0	2.3	2.6	2.3
Other Emerging Markets & Developing Countries	5.6	5.3	5.2	5.0

Source: World Economic Outlook, September 2006

The world economy has remained robust in recent years despite higher oil and commodities prices largely due to the enabling policies that allowed economies to continuously improve productivity. The strong productivity growth of the U.S. economy over the last decade or so has contributed to this purple patch of the world growth. Equally important was impressive productivity growth in emerging markets and developing countries.

An investigation of the sources of labor productivity growth in Asia revealed that Asian labor productivity growth has benefited not just from fast accumulation of physical and human capital rather from total factor productivity (TFP) growth-growth that typically comes from the factor of producing more efficiently (World Economic Outlook, September, 2006).

Growth in the United States is estimated at 3.4 percent in 2006 and forecasted to slowdown to 2.9 percent in 2007. The underlying assumption for this forecast is the expectation that consumption and residential investment growth will slow further as the housing market weakens, but that business investment is expected to rebound against the background of strong profits and limited spare capacity.

Growth in the Euro area is forecasted to rise to 2.4 percent in 2006 the highest rate in six years before moderating to 2 percent in 2007. Stronger corporate balance sheets have paved the way for higher investment, rising employment, and a better-balanced expansion. The slowing in 2007 would largely reflect the impact of scheduled tax increases in Germany.

The Japanese economy is estimated to grow by 2.7 percent in 2006, on account of increases in domestic demand. Growth is projected to moderate to 2 percent in 2007, reflecting the impact of further rise in oil prices, a cooling U.S. economy, or a sharp appreciation of the Yen against the backdrop of a disorderly unwinding of global imbalances. Recent developments reveal that after seven years of falling prices, Japan has finally escaped from entrenched deflation.

Growth in emerging markets and developing countries would remain very strong at 7.3 percent in 2006, and slow down only marginally to 7.2 percent in 2007. Growth continues to run above 8 percent in emerging Asia, with much of the momentum due to vibrant expansions in China and India. In China, real GDP grew by 10.2 percent in 2005. This would sustain at around 10 percent in 2006 and 2007.

Aggregate growth in Sub-Saharan Africa (SSA) is expected to slowdown to 5.2 percent in 2006 from 5.8 percent in 2004 mainly due to a temporary slowdown in oil production in several countries and the convergence of growth in South Africa to more sustainable levels. Sub-Saharan Africa is currently enjoying its strongest period of sustained economic expansion since the early 1970s. Growth exceeded 5 percent for the third successive years. It is projected to increase to 6.3 percent in 2007 as oil output recovers in Nigeria and new oil fields in Angola and Equatorial Guinea come on stream.

Growth in oil-importing countries of SSA has also been surprisingly robust, despite higher oil prices and the removal of international textile trade quotas, which has adversely affected a number of countries, particularly Lesotho and Swaziland. Growth in oil-importing countries held up so well in the face of high oil prices, largely cushioned by the rise in non-fuel commodity prices supported by global economic developments.

The improved growth performance in sub- Saharan Africa in recent years is very encouraging, but it still falls well short of the 7 percent annual growth needed to meet the Millennium Development Goals (MDGs) of halving poverty by 2015. It is important that governments in the region continue to press ahead with reforms to promote private sector investment including foreign direct investment, which remains low and largely concentrated in Nigeria and South Africa, and employment. Such reforms will need to encompass further trade liberalization, reduced government intervention in the economy, improvements in the business environment through the streamlining of regulations and improved governance, the development of infrastructure, and the further strengthening of economic institutions.

9.1.2 World Trade

The volume of world trade in goods and services continued to expand in 2006. It is estimated to expand by 8.9 percent in 2006 and is further projected to increase by 7.6 percent in 2007. Imports of goods and services by advanced economies rose by 7.5 percent in 2006 from 6 percent in 2005. Similarly, imports by emerging and developing countries grew significantly at a rate of 13 percent in 2006. On the other hand, exports of goods and services from advanced economies and emerging and developing countries increased by 8 and 10.7 percent in 2006 and are projected to expand by 6 and 10.6 percent in 2007, respectively.

However, global imbalances remain large and the potential for a disorderly unwinding of global imbalances remains a concern. Despite acceleration in export growth, the U.S. current account deficit is expected to near 7 percent of GDP in 2007 while surpluses in oil exporters and a number of Asian countries are expected to stay high, with China's surplus remaining in excess of 7 percent of GDP. Joint policy efforts would help to ensure a smooth reduction of global imbalances. An orderly private sector–led adjustment, involving a rebalancing of demand across countries, with accompanying further depreciation of the U.S. dollar and exchange rate appreciations in many surplus countries (notably in parts of Asia and oil producers), remains the most likely outcome. Efforts are needed to reinvigorate the process of multilateral trade liberalization in spite of the apparent deadlock in the Doha Round. Trade liberalization on a nondiscriminatory basis remains the best way to open up new global growth opportunities and the threat of protectionist pressures needs to be firmly resisted.

9.1.3 Inflation and Commodity Prices

Sustained high rates of global growth have absorbed spare capacity and led to some emerging signs of inflationary pressures. Headline inflation in a number of advanced economies has for some time been above central bank comfort zones, pushed up by rising oil prices, but there are now signs of increases in core inflation and inflation expectations, most notably in the United States. In emerging markets, a number of countries including Argentina, India, Russia, South Africa, Turkey, and Venezuela are facing price pressures following sustained periods of rapid growth or large exchange rate depreciations.

Consumer price inflation in advanced economies is estimated at 2.6 percent in 2006 against 2.3 percent in 2005.

In contrast, CPI inflation in emerging and developing countries is projected to slowdown to 5.2 percent in 2006 from 5.3 percent in 2005.

The average price of oil is estimated to increase by 29.7 percent in 2006 to reach USD 69.2 per barrel from USD 53.35 per barrel in 2005. Oil prices have been supported by tight spare capacity in global markets both in production and refining against the background of buoyant GDP growth, security concerns in the Middle East and continued risks to production in some large producers elsewhere, notably, in Nigeria.

The prices of non-fuel commodities, comprising industrial metals, food, beverages and agricultural raw materials, on average, are estimated to rise by 22.1 percent in 2006, largely due to the continued upturn in the prices of metals. Metal prices are estimated to increase by 45 percent in 2006 relative to 2005, spurred due to strong demand from emerging markets, particularly China and supply constraints due to deteriorations in ore quality and production disruptions caused by land slides and labor disputes.

Major central banks have responded to increases in prices by tightening monetary policy. The U.S. Federal Reserve and the European Central Bank continued to raise interest rates through June and the Bank of Japan ended its zero interest rate policy in July, 2006.

9.1.4 Exchange Rates

Since 2001, the U.S. dollar has depreciated against the Euro and Pound. The US dollar depreciated from USD 0.896/Euro in 2001 to USD 1.246/Euro in 2005 and further estimated to depreciate to USD 1.250/Euro in 2006. Similarly, it is estimated to depreciate to USD 1.821 per pound in 2006 from USD 1.440 per pound in 2001.

The recent depreciation of the U.S. dollar seems to reflect in part perceptions that with the U.S. expansion at a more mature stage, interest differentials vis-à-vis the other major currencies are likely to narrow, as well as increased market concern with global imbalances as the U.S. current account deficit has continued to widen and the surpluses in parts of emerging Asia and oil exporters have increased further.

9.1.5 External Debt

Total external debt of other emerging market and developing countries is estimated at USD 3150.6 billion in 2006 from USD 3012.3 billion in 2005 and is projected to rise further to USD 3352.1 billion in 2007. The lion's share of the debt (over 77 percent) was long-term loans. In terms of creditors, loans from private creditors accounted for 46.6 and 49 percent of total debt in 2005 and 2006, respectively. In contrast, total external debt of African countries slowed down to USD 244.1 billion in 2006 and further to USD 243.2 billion in 2007 from USD 289.4 billion in 2005. Official loans accounted for 73 and 66 percent of Africa's total external debt in 2005 and 2006, respectively.

The debt burden of other emerging market and developing countries, measured by both the ratio of external debt to GDP and the ratio of external debt to exports of goods and services tend to decline over time. The ratio of external debt to GDP declined from 28.9 percent in 2005 to 26.2 percent in 2006 and is projected to further slowdown to 25.2 percent in 2007.

The ratio of external debt to exports of goods and services is estimated to slowdown to 66.5 percent in 2006 from 76.9 percent in 2005. However, the ratios vary across the regional groups. The ratio was highest for Western hemisphere (111 percent) followed by Central and Eastern Europe (104.5 percent). On the other hand, this ratio was lowest for Middle East countries (33 percent) followed by developing Asia (49 percent) and Africa (64 percent).

Debt service payments as percent of exports of goods and services also declined to 13.3 percent in 2006 from 15.5 percent in 2005. It is also projected to fall further to 11.1 percent of exports of goods and services in 2007, presumably associated with HIPC debt relief.

9.1.6 Capital Flows

Net capital inflows to emerging and developing countries rose to USD 238.5 billion in 2005 from USD 205.9 billion in 2004, largely driven by a surge in net private capital inflows. Net private capital inflows has increased over time and reached USD 255.9 billion in 2005 from USD 176.9 billion in 2004. Net capital inflows is projected to slowdown to USD 211.4 billion in 2006 and further to USD 182.2 billion in 2007 owing to the projected large net outflows in portfolio investments and other private capital. Net private capital flows to African countries amounted to USD 29.4 billion in 2005, up by 82.6 percent compared with inflows of USD 16.1 billion in 2004, spurred by a surge in commodity prices and debt relief. It accounted for 12.3 percent of net inflows to emerging and developing countries. It is projected to decline to USD 24.9 billion in 2006 and further to USD 21.7 billion in 2007.

9.2. Implications of International Economic Developments on the Ethiopian Economy

Sustained high rates of global economic growth would increase foreign demand for Ethiopian products in the international market, thereby boosting exports. At the same time, high demand for non-oil commodities would increase the prices of these commodities. Policy makers, however, should anticipate the risk that there is more likely to be a robust supply response in the future and hence a price decline as investment increases to meet the higher demand. This calls for continued and concerted action to diversify exports so as to minimize vulnerabilities to external shocks.

The continued sharp increase in oil prices has been a burden on Ethiopian economy. The upsurge in the international oil prices is expected to widen the trade and current account deficits and reduce the profit margins of domestic industries and their international competitiveness. It will also have some impact on real GDP growth and monetary policy operations.

As a policy, the Ethiopian government has opted to continue limiting the full impact of higher oil prices on domestic retail prices by subsidizing some of the petroleum products. As this measure has fiscal implications and price distortion effects, it can only continue for some time until longer-term solutions are put in place.

The continued depreciation of the US dollar and the corresponding appreciation of the Euro is likely to result in the depreciation of the real effective exchange rate of the Birr, thereby improving the external competitiveness of the country, particularly with Europe, its major export market.

9.3 Highlights of Important International Meetings*

9.3.1 Meeting of the Intergovernmental Group of Twenty-Four

During their seventy-sixth meeting held on September 16, 2006, in Singapore, Ministers of the Inter-Governmental Group of Twenty-Four on International Monetary Affairs and Development stressed the importance of reaching early agreement on a credible and time-bound package of reforms that would ensure an increase in the voice and representation of developing countries in the Bretton Woods Institutions (BWIs). The reforms should include measures to enhance the

* Extracted from the respective Communiqués.

participation of low-income countries in the decision-making and management structures of the BWIs, including through, but not limited to, additional Alternate Executive Directors and Senior Advisors for chairs with the largest constituencies.

In this regard, Ministers point out that the current package of reforms do not adequately address the fundamental issue of the under representation of developing and low-income countries as groups.

They noted that the emerging market countries, other developing countries, and economies in transition account for over half of global GDP measured in terns of purchasing power parity, hold most of the world's international reserves, and represent a majority of the world's population. In order to reflect this new reality in the world economy and increase the legitimacy and relevance of the BWIs, the voting power of developing countries and low-income countries as groups should be expeditiously increased and protected, they reaffirmed.

Ministers reiterated that any package of reforms should include both an early and substantial increase in basic votes-at least a tripling-and a new quota formula that accurately reflects the relative economic size of developing countries in

With regard to global economic prospects, the Ministers welcomed the ongoing and broad-based global growth performance in 2006, but underscored that risks to the global outlook have increased, particularly amid concerns over growing global imbalances, rising inflation and tighter monetary policies, volatile oil prices, the breakdown in the Doha Round of trade negotiations, a cooling in the U.S. housing market, and increased geopolitical tensions.

Ministers stressed the pressing need for early and meaningful efforts to address global imbalances through a concerted response, including fiscal adjustment and efforts to increase household savings in the United States, structural reforms in Europe and Japan, financial sector reform and increased exchange rate flexibility in emerging market countries the world economy. Such a formula should take into account GDP at purchasing power parity, as well as countries' vulnerabilities to commodity price fluctuations, capital flows, and other exogenous shocks, noted the Ministers.

where warranted by economic fundamentals, as well as improvements in the business climate in many other developing countries.

Ministers expressed deep disappointment about the suspension of the Doha Round of multilateral trade negotiations. They stressed that the current trading system is heavily biased against developing countries, especially the least developed, particularly owing to the wide array of harmful subsidies, tariff escalation schemes, and non-tariff restrictions maintained by industrialized countries.

Ministers called for an urgent resumption of negotiations, noting that a failure to overcome the current impasse risks squandering years of effort and an important opportunity to make progress in areas of interest to all countries, while opening the door to an exacerbation of protectionist trends across the globe. In this regard, they urge the IMF and World Bank to support this effort, including by helping to make the case for the Round by highlighting its potential economic benefits, as well as the costs to all countries of trade distortions and barriers, particularly from agricultural subsidies and tariff escalation schemes in advanced economies.

Regarding support for Low-Income Countries (LICs), they noted that official development assistance to low income countries has not increased, despite the renewed pledge made by the international community at the UN Millennium Review Summit in 2005 to help accelerate progress toward the MDGs. Ministers underscored that success will require significant scaling up of efforts on the part of both donors and aid recipients, in terms of increased resources, better policies and improved governance, and enhanced aid effectiveness.

Ministers welcomed the debt reduction delivered through the enhanced HIPC Initiative and the MDRI. They called on the donor countries to provide the necessary resources to extend the MDRI to all LICs. They stressed that the debt sustainability framework that has been designed by the IMF and the World Bank for LICs must be flexible and pay due regard to country circumstances. Ministers called on donors to provide enough grants and highly-concessional loans to LICs to finance development needs, while ensuring debt sustainability. They encouraged donors to deliver their assistance more efficiently and predictably, and to align such flows with countries' own strategies for reaching the MDGs. Ministers urged the full implementation of the Paris Declaration on Aid Effectiveness.

As to the strategic issues for the IMF, Ministers welcomed the initial discussion in the IMF on a new instrument that would guarantee high-access financial support to developing countries with market access that have strong macroeconomic policies nonetheless remain vulnerable to shocks. They urged the IMF to move expeditiously to develop and implement such an instrument.

Ministers underlined that such a facility must allow automatic and upfront drawings for eligible countries. Ministers stressed that there should be no conditionality associated with the new facility beyond maintaining macroeconomic stability and reducing vulnerabilities.

Concerning strategic issues for the World Bank, they emphasized that, as poverty reduction and the achievement of the MDGs are at the heart of the World Bank's mission, any strengthening of its work on governance and anticorruption should serve to advance this mission. Ministers stressed the fundamental importance of country ownership to ensure sustainable outcomes, and they encouraged the Bank to work closely with government authorities to support their own plans and priorities. In this context, and recognizing its multilateral character, Ministers underscored that the Bank should not disengage from supporting its members, so as not to penalize the poor. Given the political dimension of governance, they stressed the need to delineate more clearly the aspects of governance that are within the Bank's mandate.

They also noted with concern the large and growing negative net transfers from the World Bank to middle-income countries (MICs), which is due in large part to the high costs of doing business with the institution. Continued engagement with MICs is fundamental to the Bank's development mandate, its financial health, and its sustained role as a knowledge bank, the Ministers stressed. Poverty in its various dimensions is still high in MICs, with most MICs continuing to face major challenges in reaching the MDGs. They noted that there has been little progress on the use of country systems, and note their importance in reducing the non-financial cost of doing business and in strengthening countries' institutional capacity. As a result, Ministers urged the Bank to take the necessary actions to achieve timely progress in this critical area.

9.3.2. Meeting of the International Monetary & Financial Committee

The International Monetary and Financial Committee stressed the importance of IMF quota and voice reforms so as to safeguard and enhance the effectiveness and credibility of IMF. Starting with initial quota increases for China, Korea, Mexico, and Turkey, a package of reforms designed by the Executive Board, when implemented, would make significant progress in realigning quota shares with members' relative positions in the world economy and, equally important, in enhancing the participation and voice of low-income countries in the IMF as set out in the resolution. Towards this effort, the Committee urged the Executive Board to work constructively and expeditiously on all elements of the reforms so as to garner the broadest possible support, underlined the importance of timely implementation of the program, and calls on the Managing Director to provide a status report at its next meeting.

The Committee welcomed the ongoing strong and broad-based global economic expansion. Even though growth is expected to remain robust in 2007, the Committee noted that there are downside risks from the possibility of a continued build-up of inflationary pressures, a slowdown in consumption in a number of countries, continuing high and volatile energy prices, and the spread of protectionism. The Committee agreed that in the period ahead, the IMF should focus on supporting its members in promoting policies for: reducing global imbalances while sustaining global growth; addressing the impact of high oil prices, in particular on the most vulnerable countries; managing the likely transition to less generous liquidity conditions; and ensuring medium-term fiscal sustainability and financial stability.

Expressing its deep disappointment that the trade negotiations have been suspended, the Committee urged all WTO members to maintain their commitment to the rules-based multilateral trading system, resist protectionist calls, and preserve progress that has already been made. In this regard, the Committee called for leadership from the major trading nations to work urgently toward an early resumption of the negotiations and successful outcome by the end of the year, based on a commitment to a comprehensive package on agriculture, industrial products, and services, to which all countries will need to contribute.

Concerning global imbalances the Committee stressed the need to implement different strategies that involve steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil producing countries.

Regarding high and volatile prices in world energy markets, the Committee welcomed the actions taken to address capacity constraints in oil production, and calls for continued measures from all sides to improve the supply-demand balance in oil markets over the medium term. This will involve increased investment to build up adequate production and refining capacity, incentives to encourage energy conservation by consumers, steps to improve the quality and transparency of oil data, and closer dialogue among oil producers and consumers.

The Committee also emphasized that the IMF should give priority to enhancing the effectiveness of its work in low-income countries by focusing on sustainable growth and macro-critical areas that support the achievement of the MDGs. It underscored the importance of helping countries reap the benefits of higher aid and debt relief, and avoid a new build-up of unsustainable debt. Nevertheless, the Committee stressed that the debt sustainability framework jointly developed by the IMF and the World Bank is the primary tool to be used by borrowers and creditors in assessing alternative financing strategies, identifying emerging debt-related vulnerabilities, and developing coherent lending practices, and urges all creditors and borrowers to use the framework in their lending and borrowing decisions. The Committee urged all creditors to work with the IMF and the World Bank to adhere to responsible lending. The Committee, however, looked forward to further refinements to the framework and the development of practical guidelines for borrowers and creditors.

9.3.3 Meeting of the Development Committee

The Committee noted that pledges made last year to substantially increase the volume of official development assistance (ODA), including a doubling of aid to Africa by 2010, must be delivered in a predictable manner. It urged those donors that have not done so to make concrete efforts towards the target of 0.7 percent of Gross National Income as ODA in accordance with their commitments. Moreover,the Committee, looked forward to a successful IDA 15 replenishment next year and urged donors to ensure that their commitments to make the multilateral debt relief initiative (MDRI) and the Heavily Indebted Poor Countries (HIPC) initiative additional to other aid flows be met.

The Committee stressed the necessity of translating the international commitments to improve aid effectiveness embodied in the principles of the Paris Declaration into action at the country level and called on the Bank to deliver on its commitments to scaling up aid effectiveness, including the implementation of the best practice principles identified in the Bank's conditionality review. The Committee noted the country-based "results and resources meetings" approach to facilitate scaling up aid now being piloted in several African countries with the help of the Bank and the Development Assistance Committee, and urged developing countries to prepare well-defined programs for using scaled up aid to step up the poverty reduction effort

The Committee welcomed the progress report on Education for All-Fast Track Initiative (EFA-FTI), and the contribution it is making to increasing primary school completion rates. The initiative offers a promising approach to donor harmonization and scaling up at the sectoral level. We recognized the importance of country ownership and the quality of education, the need to expand the initiative to larger countries and fragile states and called for predictable and long-term funding for this initiative, including domestic funding. It also urged the Bank to strengthen its work on measurement of learning outcomes in order to ensure continuous attention to the quality of education.

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The Committee welcomed the substantial reduction of debt stocks and noted the increase of poverty-reducing expenditures of the 29 HIPCs that have reached the decision point. It also welcomed the implementation of the MDRI by the IMF, IDA and the African Development Fund and noted that debt relief has provided many low-income countries with additional resources that can be used to make progress towards the MDGs. In this regard, the Committee, however, cautioned against excessive borrowing after the relief which may lead to re-emergence of debt distress. The Committee, therefore, underscored the importance of the Joint Debt Sustainability Framework of the Fund and the Bank for low-income countries in helping ensure that new borrowing in post-MDRI countries does not undermine their long-term debt sustainability, and look forward to the reviewing the framework. To this end, the Committee asked all the multilateral development banks, bilateral donors, export credit agencies and commercial creditors to adhere to this framework. Noting that the de facto suspension of the Doha negotiations represents a setback in an effort to make more rapid progress towards achieving the MDGs, the Committee re-emphasized the importance of the multilateral trading system and called upon all WTO members to avoid backsliding and provide trade ministers with the necessary flexibility to resume the negotiations by the end of the year. It also called on the Bank and the Fund to continue their global advocacy role on trade and development, and to foster the integration of trade into country programs. While recognizing that aid for trade is not a substitute for trade liberalization, the Committee reiterated its commitment to expanding the funding and strengthening the mechanisms Aid for Trade.

The Committee welcomed the progress made in developing a Clean Energy Investment Framework, including the review of the adequacy of existing financial instruments as the global community faces a major challenge in securing affordable and cost-effective energy supplies to underpin economic growth and poverty reduction while preserving the local and global environment. The challenge requires sound country energy policies and regulatory frameworks. In this respect, the Committee supported the Bank's approach in addressing the three inter-related issues of: (i) energy for development and access to affordable energy for the poor; (ii) the transition to a low carbon economy; and (iii) adaptation, and continued support on each of them. In particular, the Committee recognized lack of access to energy as an acute problem in many low-income countries, especially in Sub Saharan Africa, supported the Action Plan for improved energy access and urged donors to provide additional funding and other assistance required.