

I. OVERVIEW

The first quarter of 2004/05 marked a decline in the general level of inflation to 2.8 percent from 5.4 percent in the preceding quarter and 4.5 percent in the same period of last year, mainly associated with low level of cereal prices. Non-food inflation, a proxy for core inflation, on the other hand, rose by 0.9 and 2.3 percentage point and reached 2.7 percent, reflecting, among others, the upward movement in the prices of construction materials, petroleum products and house rents.

Spurred by a substantial rise in domestic credit growth and a marginal increase in net foreign assets, broad money expanded to Birr 34.6 billion in the review period, depicting a quarterly and annual growth rates of 3 and 13 percent, respectively. Similarly, reserve money, which is composed of currency in circulation and deposits of commercial banks at the National Bank of Ethiopia rose by 5.9 percent and 16.7 percent and stood at Birr 14.2 billion. This continuous expansion of reserve money, particularly the excess reserves of commercial banks was one of the major challenges to the monetary policy during the first quarter of 2004/05. Another challenge was the continued negative real interest rate owing to a high rate of annual core inflation (6 percent) vis-a-vis the low weighted average yields on T-bills and government bonds.

Developments in the external sector revealed the worsening of the overall balance of payments from a deficit of USD 118.2 million in the preceding quarter to USD 153.2 million in the first quarter of 2004/05. This was mainly attributable to a widening of trade deficit and a slowdown in net service inflows, public transfers and capital accounts. Mirroring the deteriorations in the overall balance of payments, the net reserve position of the country has registered a reserve draw-down of USD 132.9 million. Nevertheless, the gross official reserves of the country was sufficient to cover 4.3 months imports of goods and non-factor services of the next year.

With regard to exchange rate movements, the weighted average official exchange rate depreciated by 0.099 percent and stood at Birr 8.6408/ USD in the review quarter compared with the preceding quarter. In contrast, the average parallel market rate appreciated by 0.1 percent and reached Birr 8.7143/USD. Due to this contrasting developments, the spread between the parallel and the official exchange rate narrowed to 0.85 percent in the review quarter from 1.07 percent in the preceding quarter.

On the fiscal front, the overall fiscal deficit (including grants) rose to Birr 1.9 billion showing an increase of 97 percent and 1.1 percent compared to the same period of last year and the preceding quarter respectively. The deficit was largely financed by net external borrowing and net domestic borrowings.