

## I. OVERVIEW

During the second quarter of 2004/05, headline inflation decelerated to 1.1 percent from 2.4 percent in the preceding quarter, driven by a decline in food inflation from 3.1 percent in the previous quarter to 0.8 percent in the review quarter. In contrast, non-food inflation, which is a proxy for core inflation, rose to 1.7 percent from 0.6 and 0.7 percent in the preceding quarter and the same period of last year, reflecting a surge in prices of oil, construction materials, medical care and health facilities.

Developments in the monetary sector revealed domestic liquidity expansion as broad money supply depicted a quarterly and annual growth rates of 3.6 and 13.8 percent, respectively, and stood at Birr 35.9 billion, largely on account of a rise in domestic credit extended to the non-government sector and a surge in net foreign assets. The review period also witnessed a substantial build-up in reserve money spurred by expansion of commercial banks' reserve holdings with the NBE. This excess liquidity of commercial banks continued to pose a challenge to the effectiveness of the monetary policy instruments during the second quarter of 2004/05.

With regard to the activities of the banking system, total resources mobilized by the banking system as at end December, 2004, reached Birr 2.8 billion, up by 27.7 percent vis-a-vis the preceding quarter. Similarly, fresh loan disbursements by the banking system amounted to 2.6 billion, depicting an increase of 13 percent and 74.1 percent over the preceding quarter and the corresponding quarter of 2003/04. Ownership wise, the lion's share of fresh loan disbursements (84.4 percent) went to the private sector mirroring the effort of the government to make the private sector an engine of economic growth.

On external sector front, the second quarter of 2004/05 exhibited a favorable development as the overall balance of payments depicted a turn-around from a deficit of USD 154.5 million in the previous quarter to a surplus of USD 43.3 million in the review quarter. This good performance was the outcome of the narrowing of the merchandise trade deficit and a surge in net services, unrequited transfers and capital account. Reflecting improvements in the overall balance of payments, net foreign reserves of the banking system increased by USD 57.6 million in the review quarter. Consequently, at the end of the second quarter, gross official reserves of the country was sufficient to cover 4.6 months of imports of goods and non-factor services of next year.

Meanwhile, developments in the foreign exchange market revealed the continued but steady depreciation of the official exchange rate against the US Dollar. Accordingly, the average weighted inter-bank exchange rate of Birr depreciated by 0.09 percent and stood at Birr 8.6483/USD vis-a-vis the preceding quarter. During the same period, the Birr value in the parallel market depreciated by 0.01 percent only reaching Birr 8.7152/USD. As a result, the spread between the parallel and the official exchange rates narrowed to 0.77 percent in the second quarter of 2004/05 from 0.85 percent in the previous quarter.

With regard to the performance of the fiscal sector, Federal Government fiscal operations during the second quarter of 2004/05 resulted in an overall fiscal surplus of Birr 969.4 million in contrast to a deficit of Birr 1980.5 million in the preceding quarter, largely attributable to the disbursement of World Bank budget support grant and a substantial rise in domestic revenue.