I. OVERVIEW

Inspite of the decline in food inflation from 0.8 percent in the preceding quarter to 0.2 percent in the review quarter (January - March, 2005), headline inflation rose to 1.5 percent from 1.1 percent in the preceding quarter, largely due to a substantial rise in non-food inflation. Non food inflation, a proxy for core inflation, reached 3.9 percent, the second highest quarterly increase since 2000, mirroring upward movements in the prices of construction materials, fuel, medical care and house rents.

Domestic liquidity, as measured by broad money, continued to expand and reached Birr 36.9 billion at the close of the third quarter of 2004/05, indicating a quarterly and annual growth of 2.7 and 16.3 percent, respectively. This was attributable to a substantial rise in domestic credit extended to non-government sectors and a marginal rise in net foreign assets of the banking system. Similarly, reserve money picked up to Birr 20.6 billion, depicting a significant growth of 77.7 percent compared to a year earlier, as commercial banks' reserves at the NBE surged.

With regard to the interest rate structure of commercial banks, simple average savings deposit rate remained at the previous quarter level of 3.1 percent, while average interest rate on time deposits, picked up and reached 3.69 percent relative to 3.61 percent. The weighted interest rate on demand deposits, on the other hand, slightly declined to 0.89 percent from 0.9 percent in the previous quarter.

In the external sector front, the overall balance of payments registered a surplus of USD 30.9 million, which was 30.3 and 70.3 percent lower than that of the preceding quarter and the corresponding period of last year, respectively. This was largely attributed to slowdowns in receipts from services and official transfers. Official transfers nose-dived to USD 62.1 million from USD 224.4 million in the second quarter of 2004/05, a quarter that marked a substantial official assistance in the form of cash. Reflecting the recorded surplus in the overall balance of payments, the reserves of the banking system registered a reserve buildup of USD 60 million, notwithstanding a reserve drawdown of USD 91.7 million by the NBE. The decline in reserve holdings of the NBE largely reflects the attempt of NBE to stabilize the value of the Birr against USD through interventions in the inter-bank foreign exchange market by providing banks with foreign exchange to meet their clients' rising import demand. Nevertheless, the gross official reserve of the country was sufficient to cover about 4.2 months of imports of goods and non-factor services of the next year.

The weighted average inter-bank exchange rate of the Birr against USD depreciated by 0.082 percent and stood at Birr 8.6554 per USD compared to the preceding quarter, while it appreciated by 0.22 percent in the parallel market. In effect, the spread between the parallel and the official exchange rate narrowed to 0.47 percent from 0.77 percent in the previous quarter.

The third quarter of 2004/05 marked the continued use of treasury bills as a non-inflationary means of deficit financing and an instrument of monetary policy to mop-up excess liquidity of commercial banks. Accordingly, the amount of T-bills supplied increased by 28.4 percent and reached Birr 7.8 billion, satisfying 64.6 percent of the demand. The existence of excess demand over supply, spurred by fierce competition among few but highly liquid financial institutions has depressed the average annual weighted yield of T-bills of all types of maturity. For instance, the average weighted yield for 28-day bills dropped from 0.3 percent during the previous quarter to 0.15 percent in the review quarter.

With regard to government fiscal performance, government operations exhibited an overall fiscal deficit of Birr 2044 million compared to a surplus of Birr 969.4 and 134 million in the preceding quarter and the corresponding period of last year, respectively, owing to lower revenue generation and increased outlays for all components of expenditures.