I. OVERVIEW

The rising trend in inflation moderated during the second quarter of 2006/07 with general inflation rate of 2.6 percent exhibiting a significant slowdown compared with 7.3 percent inflation recorded in the first quarter. It was, however, higher than the -0.1 percent inflation rate registered during the same period of the preceding fiscal year. Both food and non-food inflation contributed to the slowdown in the general inflation rate.

Monetary growth continued to be driven by expansion in domestic credit, which also reflects continued economic expansion. Broad money supply (M_2) showed quarterly and annual growth rate of 2.1 and 18.3 percent and reached Birr 49.8 billion at the end of the second quarter of 2006/07 mainly due to the growth in domestic credit to non-government sector.

Base money grew by 5 percent on quarterly basis while it declined by 8.4 percent on yearly basis to reach Birr 22.2 billion at the end of the second quarter of 2006/07. The quarterly growth was due to a respective 4.5 and 5.8 percent rise in currency in circulation and commercial banks' deposit at the NBE. Similarly, excess reserves of commercial banks slightly increased by 1.8 percent over the preceding quarter but plummeted by 42.8 percent annually.

There were no significant changes in the interest rate structure of banks. Average savings and demand deposit rates remained at 3.08 and 0.06 percent while weighted time deposit rate slightly rose from 4.0 percent to 4.01 percent. Average lending rate, on the other hand, remained at 10.5 percent. Due to the persistent higher level of inflation, real deposit rates and T-bills yields remained negative.

Deposit liabilities of the banking system reached Birr 49.3 billion at the end of the second quarter of 2006/07 reflecting quarterly and annual growth rate of 3.4 and 18.5 percent respectively. Similarly, new loans disbursed by the banking system during the quarter grew by 42.4 and 20.4 percent on quarterly and annual basis and reached Birr 4.3 billion.

As a result, outstanding loan of the banking system at the end of December 2006 reached Birr 41.8 billion, up by 2.3 and 30.4 percent compared to the balance at the end of the preceding quarter and the same quarter of last year, respectively.

In the external sector, the overall balance of payments registered a deficit of USD 12 million, which was 83 percent lower than the preceding quarter. This was largely due to the improvements in the service sector and higher inflows through private and public transfers which more than offset the deterioration in the trade balance. Similarly, compared with the same period of last year, the overall balance deficit narrowed by 92 percent largely as a result of the rise in private transfers and capital account. On the other hand, merchandise trade deficit widened from USD 894.8 million in the preceding quarter to USD 1,048.9 million due to a 16 percent rise in imports which more than offset the 10 percent rise in exports. The review quarter also witnessed a reserve build-up of USD 10.2 million by the banking system.

The Birr continued to depreciate against the US dollar in the inter-bank foreign exchange market. During the quarter, the average exchange rate in the inter-bank market reached Birr 8.7197/USD, depicting quarterly and annual depreciation rates of 0.24 and 0.49 percent. The exchange rate in the parallel market also depreciated by 0.21 percent on quarterly basis but appreciated by 1.3 percent on annual basis and reached Birr 8.9059/USD. As a result, the average spread between the official and the parallel exchange rates narrowed to 2.1 percent, from 2.2 and 4.0 percent in the preceding quarter and the same quarter of last year, respectively. However, the real effective exchange rate appreciated by 2.4 and 7.9 percent vis-à-vis the preceding quarter and the corresponding period of last year mainly due to higher domestic inflation vis-à-vis the inflation in major trading partner countries.

Second quarter of 2006/07 also witnessed improved government fiscal operations as fiscal deficit (including grants) declined by 60.6 and 14.8 percent compared to the preceding quarter and the same quarter of last year, respectively and reached Birr 475.2 million. Total revenue and grants also depicted a quarterly and annual growth of 30 and 36.8 percent due to higher tax and non-tax revenue collection.

In the review period, a total of 931 investment projects with a total investment capital of Birr 23.7 billion were approved by the Ethiopian Investment Agency. The number of investment projects approved decreased by 13.5 percent compared with the corresponding period of last year while the registered capital increased by 1.5 percent. Of the total investment projects, Birr 20.0 billion (84 percent of the total) were foreign investments. Upon commencement of operation, approved projects are estimated to create employment opportunities for more than 137 thousand people.

In a nutshell, the second quarter of FY 2006/07 witnessed slowdown in the inflationary pressure, moderate monetary growth, robust credit expansion, widening current account deficit, slow but steady depreciation of the Birr exchange rate, stable interest rate, narrowing of the fiscal deficit and growing investment. Despite these mixed developments, Ethiopia is expected to register about 10 percent economic growth in 2006/07, as it has been the case in the last three consecutive years.