ETHIOPIA'S CHANGING OF THE GUARD

Brings More Than Just New Faces

africa in depth

Prime Minister Abiy Ahmed's reform agenda has been both fast-paced and far-reaching. Since coming to office less than a year ago, he has begun a reconciliation process with Eritrea after decades of conflict and cross-border animosity, put in place a young cabinet with 50% female representation, released up to 60,000 political prisoners, unbanned opposition parties including those which had been designated as terrorist organisations by previous administrations, and begun an ambitious economic reform and liberalisation programme.

These initiatives have earned Abiy a sterling international reputation while also drawing broad popular support in many parts of the country. Nevertheless, Abiy's dismantling of the ruling EPRDF's system of government also holds the potential to unleash a pandora's box of political forces that have historically resisted or objected to the country's leadership and system of government. In particular, the EPRDF's tight control over the political system and its suppression of ethnic nationalism has driven deep resentments but also limited the extent to which such forces can disrupt or indeed overturn the status quo. Under the Abiy system, there are already signs that ethnic and political forces that perceive themselves to be on the margins of the state system will increasingly seek to challenge the authority of the government and the nature of Ethiopia's ruling system as a whole.

On a positive note, Abiy has taken several measures to counter this issue. Firstly, in opening up the political system and engaging in genuine political dialogue, Abiy is managing to settle a number of socio-political disputes that have arisen to date. Secondly, formal negotiations with armed political movements such as the OLF and ONLF have resulted in disarmament programmes. Military reforms, personnel changes and investigations into corruption have also served to reduce – but not remove – intervention threats. Meanwhile, firm action has been taken to prosecute those who have directly threatened Abiy's authority following an assassination attempt in the early stages of his administration and a military protest in October that saw a large group of soldiers accost him in his office. Lastly, Abiy has systematically sought to dismantle the patronage structures of the political 'old-guard', notably tackling the TPLF's vested interests across state institutions and parastatals.

This latter course of action has created bitter resentment within the ranks of the TPLF old guard who have complained over the ethnic motivations of anti-corruption interventions and warned that this could be destabilising. In this regard, it should be noted that in the event of a political crisis or major bout of social unrest, there remains a credible risk of opportunist elements in the TPLF politico-military establishment seeking to seize back control and stop Abiy's reforms in track. However, the powers of the old guard are weakening by the day as Abiy consolidates control and gathers broader popular and international backing for his actions. The fact that the Prime Minister does not appear to be dismantling power structures in order to re-award patronage to his own allies, but rather to fundamentally alter the workings of the state, serves to limit accusations of political chicanery.

Nevertheless, Abiy's opening of the political space will unleash political forces that will inevitably undercut the EPRDF's hitherto uninhibited dominance of the political landscape. And Abiy's commitment to this process will likely be tested in the lead-up to the elections next year. The Prime Minister is clearly banking on his personality cult to carry the EPRDF through this process, yet the party will no longer enjoy its untrammelled control of the system if it continues to open the political space, as seems likely on current projections. So Ethiopia is embarking on a new political era, laced with optimism but also uncertainties.

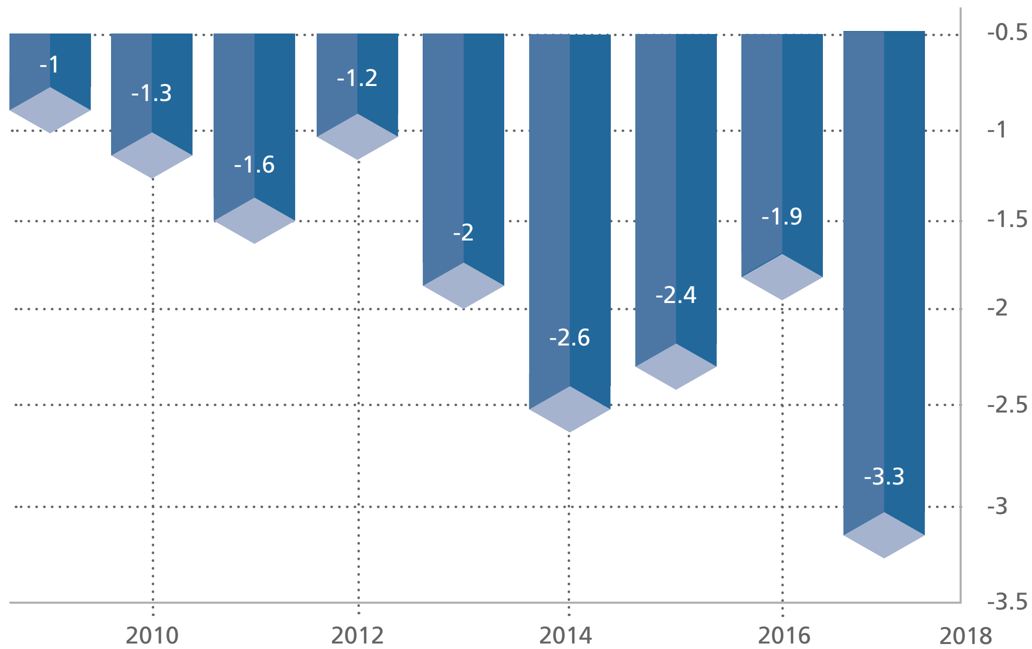
'ABIYNOMICS' TO THE FORE

While Ethiopia's economy has been Africa's stand-out performer over the last decade and the government has received recognition from international partners for the extent to which its state-led development agenda has achieved results, prominent structural risks make this approach increasingly unsustainable. Market protectionism, a weak balance of trade, high public expenditure and accordant debt accumulation are at the heart of this issue and have become the focus of government reform efforts.

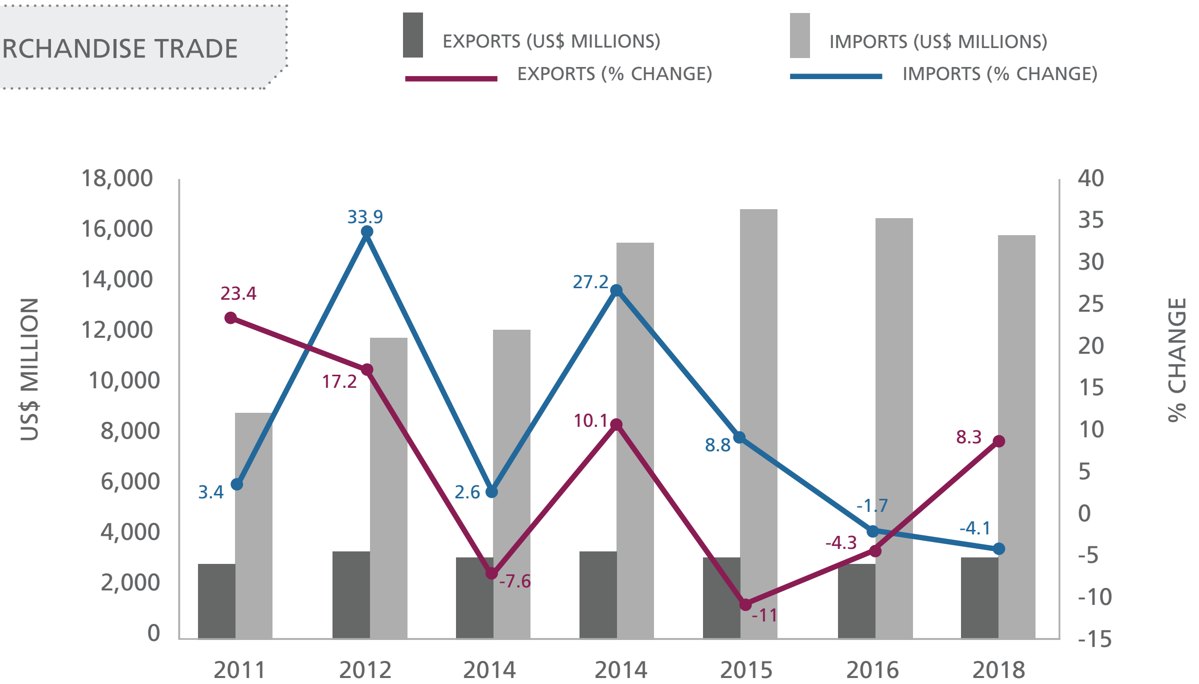
In response, the government has set out an ambitious reform strategy, enshrined in The New Horizon of Hope document. It has already taken a number of initiatives to improve public finances, such as reducing the budget deficit for 2018/19, not raising expenditure in real terms, maintaining current wage levels rather than increasing them, freezing certain capital expenditure plans notably on new projects, and reducing new money supply. Beyond these short-term initiatives, it is also embarking on notable reforms to increase private sector participation, ease the business environment, improve regional integration, and support growth in priority areas of the economy, notably where they can improve the balance of trade.

GOVERNMENT BUDGET DEFICIT (% OF GDP)

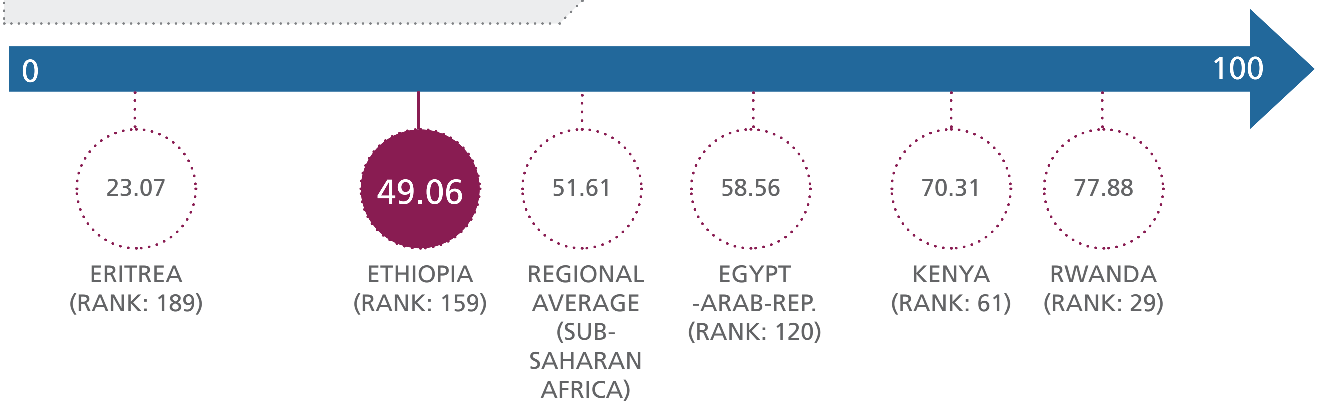
SOURCE: TRADINGECONOMICS.COM
MINISTERY OF FINANCE & ECONOMICS



MERCHANDISE TRADE



DB 2019 EASE OF DOING BUSINESS SCORE



NOTE: The ease of doing business score captures the gap of each economy from the best regulatory performance observed on each of the indicators across all economies in the DOING BUSINESS sample since 2005. An economy's ease of doing business score is reflected on a scale from 0 - 100, where 0 represents the lowest and 100 represents the best performance. The ease of doing business ranking ranges from 1 - 190.

The World Bank and IFC have been critical partners in this process, advising the Prime Minister, Ministry of Finance and other key departments directly. The World Bank's $1.2bn Growth and Competitiveness Project, launched in October 2018 and led by Nataliya Mylenko and Jean-Pierre Christophe Chauffour, is the key vehicle for this support.

IT IS STRUCTURED AROUND THREE STRATEGIC PILLARS:

(i) maximizing finance for development;
(ii) boosting competitiveness through a better environment for the private sector; and
(iii) enhancing public transparency and accountability to promote good governance.

The IMF has had a historically fractious relationship with Ethiopia, largely because its advice was not seen to align with the priorities of the former administration. When the IMF's country representative completed their term in 2013, they were not replaced. However, africapractice understands that a new representative may shortly be hired into the country in a sign that the new administration is engaging more constructively with the institution. In the short-term, the World Bank is likely to be a more relevant and influential advisor however given its direct involvement in the policy reform process.

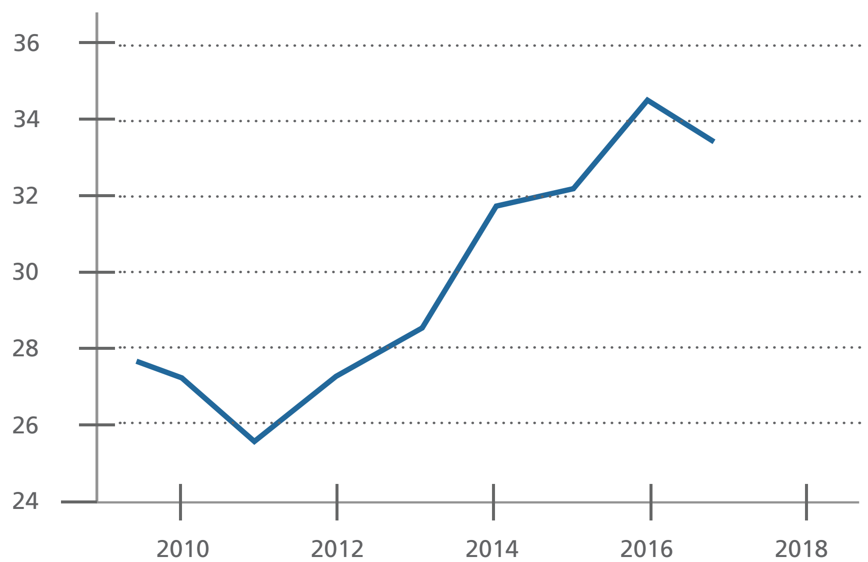
DEBT TRAJECTORY

Ethiopia was reclassified by the IMF as being at risk of debt distress in 2017. The sum of debt in itself is not necessarily the critical issue, but the growing burden of debt servicing costs is placing a strain on public finances and a drain on forex, with principal repayments on non-concessional and bilateral loans on infrastructure payments beginning to mature. China reportedly accounts for between 45-50% of Ethiopia's debt portfolio and the country has sought to reduce its exposure in light of these risks, notably turning to the Gulf states for support, as well as multilateral credit from the World Bank and IFC. Meanwhile, the Ethiopian government has sought to restructure some of its loan arrangements, shifting commercial debt into concessional forms.

Beyond these dynamics, the government has sought to both cut costs and raise revenues in order to avert a widening fiscal deficit and growing debt burden. Cost cutting has included the suspension of planned megaprojects and efforts to streamline parts of the administration. Another key component is the establishment of a PPP law and unit to encourage greater private capital in infrastructure projects, as well as the broader privatisation drive. Revenue raising has been cautious to date but as outlined in the Tax and regulatory section, we anticipate that this drive will gain greater momentum in the coming years.

GOVERNMENT DEBT TO GDP (%)

SOURCE: TRADINGECONOMICS.COM | NATIONAL BANK OF ETHIOPIA



FOREX ACCESS

The country's poor balance of trade, compounded by debt-servicing costs and an ambitious public infrastructure programme which drains forex supply, has severely constrained the business environment in recent years. The government has a strict priority list for forex supply, with debt-servicing, fuel, medical imports and agri-inputs (notably fertiliser) representing the principal priorities, after which comes the manufacturing industry. Although building strong relations with the banks and even the Central Bank (NBE) at a strategic level can help raise a firm's status in the government's prioritisation, this is unlikely to result in preferential treatment or steady access to forex, such is the extent of demand against a constricted supply.

Historically, the NBE's deputy governor has been in charge of overseeing forex awards but this position is currently unfilled, so the head of the forex directorate, Yene Hasab is likely to be the key point of contact, with the Governor also relevant on strategic issues. The NBE awards forex to the banks with prescriptive advice on priority recipients. While the Commercial Bank of Ethiopia (CBE) secures a significant portion of this forex, foreign businesses report that they have generally had more success securing forex from some of the private banks - often applying across multiple banks to increase chances.

Beyond this, the government has eased some conditions around how companies can access forex in the market. Firstly, firms are able to secure forex from exporters though this generally comes at a premium rate of interest. At times, it has also allowed foreign companies to arrange inter-company credit loans but this has been resisted by local firms which say it unfairly favours foreign business. Lastly, the government has in some instances allowed foreign banks to extend loans to firms that pay foreign suppliers outside of Ethiopia. The NBE and CBE then cover this loan, repaying in six-month instalments with interest applied. This effectively moves immediate forex demands into government debt which can be settled over a period of time rather than in one large instalment. It also allows for insurance to cover the loan.

In the long-term, government macro-economic policy is geared towards addressing the forex issue. The industrial parks strategy is designed to increase forex availability through incentivised export-oriented investments. The privatisation process will provide a much-needed short-term injection of forex. And there are slower burn conversations around the creation of domestic capital markets (by 2020), possibility of a currency float and review of some tariffing arrangements to provide for a freer market for trade - something that is also necessary if Ethiopia is to achieve its objective of World Trade Organisation accession, an initiative being led by Mamo Mehretu in the Prime Minister's Office. Ultimately however, the success of several of these initiatives as well as the move towards Public-Private Partnerships to deliver infrastructure development where previously this was led by public spending, will depend upon the creation of a far larger and more internationally integrated capital markets system that is free from its current isolated position. And while this is certainly on the government's radar, it does not appear to be an immediate priority.

BUDGET OUTLOOK

The government is currently in the process of reviewing revenue inputs and expenditure ceilings prior to the Ministry of Finance convening a budget hearing process. By mid-May, the revised and consolidated budget will be presented to the Council of Ministers, which will review and approve the budget, before being submitted to the legislature for final approval by mid-July. The overall aim of the budget is likely to be an extension of the previous one - further limiting the budget deficit by improving revenue collection but not significantly expanding expenditure, looking instead to support the private sector as a more central agent of growth.

While exact details of this process are not being disclosed publicly, it is clear that broadening the tax base and improving tax compliance is a top priority while there are also some efforts to deepen taxes in order to strengthen the 2019/20 budget. However, where this is occurring, it is largely being driven in a consultative manner by the Ministry of Finance, providing a degree of visibility for affected industries.

TAX STRATEGY

In recognition of the country's economic challenges and low tax-to-GDP ratio of 11% (compared to a regional average of 18% in sub-Saharan Africa), the government is currently conducting a comprehensive review of its tax strategy, led by the Ministry of Finance. Under its development plan, Ethiopia targeted a tax-to-GDP ratio of 17% by 2019-20 but this looks increasingly unachievable.

Nevertheless, tax reform is being undertaken in three principal ways:

1

INSTITUTIONAL REFORM:

The ERCA has been replaced by a Ministry of Revenues which has oversight of tax and customs activities, including direct oversight of the customs administration. The UK DFID is supporting a unit within the Ministry called the Tax Transformation Office, which is reviewing tax systems and processes to identify and tackle bottlenecks and inefficiencies. The Ministry of Finance has established a tax delivery unit to hold the Ministry of Revenues to account. Tax policy continues to be shaped at a sectoral level, with support from the tax policy unit in the Ministry of Finance, which has a more over-arching role to play in shaping government tax policy. This policy unit is currently focused on conducting studies on the government's tax exemptions policies as well as looking at broader equity in the tax system across different interest groups in the economy.

2

BROADENING THE TAX BASE:

The government recognises that the tax collection system is inadequate, both because large parts of the informal or grey economy go untaxed, and because compliance with tax law is poor. It is therefore on a drive to improve its auditing and oversight systems, and to run a publicity campaign – steeped in patriotism – to get people to pay their taxes. This has been supported by politicians, business executives and celebrities.

3

DEEPENING THE TAX BASE:

Although at a relatively early stage, the government is conducting both broad strategic review of its tax policies, supported by the World Bank, and specific reviews at a sectoral level. This process has been relatively cautious and has largely sought consultation with industry. We believe deepening the tax base by reviewing/revising existing tax policies or introducing new taxes will become a growing focus, but that the process will be drawn-out and will involve opportunities for consultation and advocacy.