ERITREA: A Macroeconomic Overview

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Recent Economic Developments

Prior to the border conflict with Ethiopia, Eritrea enjoyed several years of sustained income growth, moderate but stable inflation, and a gradually improving balance of payments. However, the war with Ethiopia seriously disrupted the Eritrean economy, helping to reverse ten years of development efforts. In May 2000, hostilities intensified, resulting in an estimated $565 million in property damages. This is equivalent to 93% of the country's 2000 GDP (IMF, p.5). Consequently, current macroeconomic conditions in Eritrea can best be explained as a result of the border conflict with Ethiopia and the Government of Eritrea's (GSE) subsequent efforts to reconstruct the economy.

Prospects for Growth

Prospects for growth in Eritrea depend on multiple factors. Much of current growth comes from recent donor investments in post-conflict infrastructure building and redevelopment, rather than from a substantial expansion in Eritrea's productive capacity. In fact, Eritrea still faces a food shortfall caused by declining agricultural productivity and may suffer from widespread hunger and malnutrition if further food aid from donors is not forthcoming. Thus, the recovery of the agricultural sector is seen as an important pre-condition for the restoration of economic growth, particularly in the short-term.

Longer-term prospects for Eritrea's economic growth depend on the restoration of private sector capacity. This, in turn, relies on the availability of capital and labor, improvements in infrastructure, and the availability of intermediate inputs. Although stalled, demobilization of the military has the potential to ease current labor shortages; and large-scale, donor-funded projects are expected to provide the much-needed rehabilitation of infrastructure damaged during the war.

Long-term prospects for increasing the availability of affordable capital, however, will depend greatly on the establishment of a more competitive banking system that reflects market driven interest rates, and the ability of the GSE to contain rising government budget deficits. In the interim, loans to private businesses (extended through commercial banks) are included as part of the Emergency Reconstruction Program (ERP) which is primarily being financed through World Bank loans and donor funding.

Political Reform and Donor Aid

Although most observers agree that Eritrea has demonstrated an impressive commitment to the liberalization of its economy, many donors are more skeptical of progress made on the political front. Given the country's reliance on foreign aid, the potential alienation of key donors has significant ramifications for growth. The Economist Intelligence Unit (EIU) reported in March 2002 that recent government attacks on the freedom of the press have caused donors to reconsider their involvement in development aid to Eritrea. For example, the Danish government excoriated Eritrea for its "assaults on democratic principles and human rights" and announced that the Danish Agency for Development Assistance (DANIDA) would suspend development aid in response to the slow pace of democratic reform. Eritrea faces similar difficulties with Italy, a major donor for Eritrea.

Investment and Reconstruction

The defining characteristic of the post-conflict period has been massive investment in reconstruction and development. The World Bank projects a significant increase in the fraction of output devoted to gross capital formation in 2002, from 35.3% of GDP in 2001 to 44.4% in 2002. Foreign direct investment (FDI) is also expected to grow marginally. Increases in investment are inextricably linked to the Government's desire to reconstruct infrastructure badly damaged by the war. The GSE's *Transitional Economic Growth and Poverty Reduction Strategy* (TEG), which lays out the government's policies for macroeconomic management and the promotion of economic growth, cites post-war reconstruction and development as the country's highest priority:

> Direct war damage to infrastructure and displacement of people in the country's most productive farming regions severely disrupted agricultural production during 2000 . . . The government's overriding objectives following the end of the conflict are to rebuild the economy, restore social services and complete the economic and political reforms initiated before the conflict began. Rebuilding the economy will require rehabilitating infrastructure and buildings damaged by the war, and assisting displaced people to reestablish their farms and businesses.

Much of the investment for infrastructure reconstruction is being financed through the ERP, which began in November 2000 and is slated to run through December 2002[1]:

> It is imperative to reconstruct damaged roads, bridges, irrigation and other infrastructure as quickly as possible to enable farmers to obtain the inputs they need to cultivate their crops and ship them to market. It is also critical to reconstruct power and water supply systems, health clinics and schools, and to assist war-affected people...to rebuild their lives (14).

The ERP comprises four main components including agriculture, infrastructure rehabilitation, private sector reconstruction, and social protection.

Interest Rates and the Banking System

Interest rates remain stable, but this is largely due to the fact that interest rates on government securities are administratively determined and the fact that Eritrea lacks a competitive banking system.[2] In addition, although inflation is being contained, low nominal interest rates ensure that real interest rates are negative or close to negative.

Currently, there are only three major banks, which set interest rates for the country based on their capacity to maximize the spread between deposit and loan rates. However, Eritrea's first private bank, the Augaro, is scheduled to begin operations in the second half of 2002. This could assist

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[1] The ERP is financed by a US$90 million equivalent credit from the International Development Association (IDA) and US$197 million from the Eritrean government and several bilateral and multilateral donors, for a total investment of US$287 million.

[2] Savings deposit interest rates have been stable at 6 to 6.5 percent for the last several years, and loan rates have oscillated between 8 and 12 percent.

in making interest rates more competitive, but, in the long run, the persistence of large government budget deficits can be expected to crowd out private investment

Trade and Exchange Rates
Eritrea's trade regime is among the most liberal in Africa; the number of tariff bands has been reduced from 12 to 3 and the maximum duty has been reduced from 200 to 25. However, Eritrea is neither a member of the World Trade Organization (WTO), nor does it have observer status. Either way, current trade statistics for Eritrea primarily reflect damage from the war. The balance of payments deteriorated rapidly after the onset of violence in 1998, culminating in a current account of –43 % percent of GDP in 1999, the year after hostilities broke out. Exports have fallen substantially from a 1993 peak of 33% of GDP, and now hover around 20%. Hostile relations with Ethiopia, once a major export market, have exacerbated the situation.

The ERP provides $78 million in balance of payments support to the Government of Eritrea, which is now working with the IMF to assess its policy options. Efforts are being made to increase exports in product lines where Eritrea may have a regional comparative advantage, including salt, fruits, vegetables, fish and shrimp, livestock, flowers, garments and leather. Improved relations with nearby African and Arab countries may facilitate export growth; The African Growth and Opportunity Act (AGOA) can also provide new opportunities for exports to the United States, although near term prospects for Eritrea under AGOA appear limited (TEG, p.15).

The GSE fixed the local currency, Nakfa, to the USD from independence until May 1998, when it adopted a managed float (*CCC* 15). Following the outbreak of violence, the government once again implemented exchange rate controls, fixing the rate at 10 Nakfa per USD. After the conclusion of the war and the initiation of donor negotiations in August 2001, the government lifted these controls. However, there is a high probability that collusion among currency trade houses in the country (probably at the direction of the GSE) is taking place.[3] In either case, the Nakfa has been depreciating substantially, reflecting Eritrea's balance of payments problems.

Prospects under AGOA
Although Eritrea is eligible for preferential market access to the U.S. AGOA, it has not received the required textile visa in order to take advantage of preferential treatment of apparel exports. As of the Jan-March 2002 quarter, the U.S. International Trade Commission (USITC) had reported no import trade from Eritrea. Near-term imports from Eritrea to the U.S. of fresh (unprocessed) agricultural products are unlikely given the lengthy process required in order to obtain U.S. Department of Agriculture (USDA) Animal Plant Health Inspection Service (APHIS) certification.

Government Consumption and Revenues
Government consumption as a percent of GDP increased markedly, from 49 percent of GDP in 1998 to 77.2 percent in 2001. The World Bank projects that government consumption will rise to 86 percent of GDP by 2002. Though observers had initially expected that the end of conflict would lower government spending on the military, the widespread need for infrastructure

[3] Collusion among currency trade houses is directed towards propping up the Nakfa, which is currently trading on the black market at 19.8 Nakfa to the USD while the official rate stands at 13.55 Nakfa to the USD.

redevelopment and continued military expenses associated with a delayed demobilization program have kept the government from reducing expenditures as quickly as expected.[4] In addition, fiscal revenues are low and expected to continue as such due to a general reduction of tax rates and the loss of revenues derived from trade with Ethiopia.[5]

The Pricing System

As of November 2001, the GSE intended to retain ownership of the Petroleum Corporation of Eritrea (PCE) and continues to set prices administratively (IMF). Although no fuel shortages had appeared despite repeated increases in the price of wholesale petroleum, the GSE has conceded that more frequent price adjustments for domestic fuel would help to ensure the financial viability of the PCE and promote efficient resource allocation. Other price controls that remained in place at that time apply to pharmaceuticals and bread.

Summary and Outlook

Although some progress to improve the enabling environment for private business, such as a move towards a more competitive banking system, have been put into place, the GSE continues to retain ownership of most of the productive enterprises in the country. Thus, substantial deregulation and privatization of major industries would contribute substantially toward a more positive economic outlook.

In addition, political repression and high levels of government spending are troubling aspects of the government's post-war behavior. Donors and private investors will be watching the government carefully. It is likely that unless the GSE demonstrates a commitment to political liberalization, donor relations will remain tense. Moreover, given the current conditions, investor confidence is likely to remain skittish.

Citations

CCC	"Eritrea: Country Commercial Guide." US Commercial Service, December 2001.
EIU	"Economist Intelligence Unit: Eritrea." EIU, March 2002.
IMF	"Eritrea: Staff Report for the 2001 Article IV Consultation." SM/01/338. International Monetary Fund, November 2001.
TEG	"Transitional Economic Growth and Poverty Reduction Strategy." Government of Eritrea, Asmara, August 2001.
WDI	"World Development Indicators 2002." World Bank, 2002.

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[4] Although the World Bank recently approved a $60 million loan for the first phase of an anticipated three-phase demobilization program, physical demobilization of armed forces has not as yet gone forward.

[5] The government's 2001 fiscal program included measures to simplify the tax system and improve tax and customs administration. However, the actual tax rates implemented in October 2001 were, in many cases, lower than had been discussed and, in addition, the government did not raise gasoline and diesel taxes, which were to be the main offset to the revenue reducing trade reform package.