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Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 10-Jul-2024 | Report No: PIDDA00109

BASIC INFORMATION

A. Basic Project Data

Project Beneficiary(ies)	Operation ID	Operation Name	
Ethiopia	P181591	Ethiopia First Sustainable and Inclusive Growth Development Policy Operation	
Region	Estimated Approval Date	Practice Area (Lead)	Financing Instrument
EASTERN AND SOUTHERN AFRICA	25-Jul-2024	Macroeconomics, Trade and Investment	Development Policy Financing (DPF)
Borrower(s)	Implementing Agency		
Federal Democratic Republic of Ethiopia	Ministry of Finance		

Proposed Development Objective(s)

To support the Government of Ethiopia's efforts to: (i) advance financial sector restructuring and trade liberalization; (ii) promote fiscal sustainability and transparency; and (iii) enhance social resilience and climate action

Financing (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? Yes

Is this project Private Capital Enabling (PCE)? Yes

SUMMARY

Total Financing	**1,500.00**

DETAILS

Total World Bank Group Financing	**1,500.00**
World Bank Lending	1,500.00

Decision

The review did authorize the preparation to continue

Explanation

B. Introduction and Context

Country Context

1. **Ethiopia's state-led growth model supported high growth and social improvements.** Between 2004-2018, Ethiopia was one of the world's fastest-growing economies (average real growth of 10 percent). The state-led model increased access to infrastructure, services, and better living standards. Notable outcomes include expanding proximate potable water access to 60 million more people, doubling electricity access, and a 64 percent increase in child vaccinations. Between 2004 and 2016, these advances helped reduce the national poverty rate from 39 to about 24 percent.[1]

2. **However, these achievements came at a high cost.** Expansive public investments were central to the state-led model and were facilitated by an overvalued exchange rate, financial repression, debt, and trade and other regulatory restrictions.[2] The model crowded out private investment, undermined external competitiveness, fueled inflation, and exhausted external and fiscal buffers. Between 2009 and 2019, Ethiopia's external public debt-GDP ratio nearly doubled to 28 percent of GDP, and Ethiopia engaged in a first public debt restructuring exercise in 2019 to ease growing debt pressures. Financial repression, monetary deficit financing, and directed lending to state-owned enterprises (SOEs) contributed to misallocations of investments, structurally high inflation, and growing financial stability risks. High growth did not translate into enough productivity growth and job creation. The economy's structure is broadly unchanged since 2004, and 70 percent of people rely on agriculture for their livelihoods.

3. **Persistent shocks and inadequate policy responses slowed growth, increased poverty, and triggered a debt default in late 2023.** Amid growing external imbalances and rising public debt, Ethiopia was hit by several shocks beginning in 2020, including the COVID-19 pandemic, Russia's invasion of Ukraine, the Tigray conflict, and persistent droughts. The Tigray conflict displaced over 20 million people and destroyed essential infrastructure and health services, and reconstruction cost estimates are US$20 billion. The worst drought in 40 years fuels hunger and displacement; over 15 million people still require food aid. As a result of these challenges, growth slowed to 6.5 percent between 2020-2023, and the international poverty rate (US$2.15/day) is estimated to have risen to 34.6 percent in 2023 from 27 percent in 2015. In 2021, Ethiopia requested debt treatment under the G-20 Common Framework due to increasing external financing pressures and declining official assistance. To manage FX pressures, the government tightened already onerous current account and financial sector restrictions and increased mandatory FX surrender requirements to 80 percent. As the tax-to-GDP ratio fell (now below 7 percent), the government cut spending and severely limited wage increases and social safety net payments despite persistent inflation of about 30 percent. With rising FX shortages, Ethiopia began accumulating bilateral debt arrears and missed a US$33 million Eurobond coupon payment in December 2023.

4. **Climate change and conflict amplify Ethiopia's challenges.** Ethiopia is highly vulnerable to climate change. Significant hazards include droughts, floods, volcanic activity, seismic activity, heat stress, and pest infestations. These are already contributing to humanitarian needs and internal displacement. Climate change is expected to impose significant and spatially concentrated costs on people and infrastructure. Households in rural areas, the lowlands, and the agricultural sector will be increasingly vulnerable due to land degradation, deforestation, and shifting climate hotspots to lowlands.[3]

[1] Ethiopia Poverty Assessment (2019).
[2] Ethiopia Systematic Country Diagnostic Update (2024).
[3] Climate-related average annual losses range from 1- 1.5 percent of GDP this decade, rising to 5 percent in the 2040s, and at the upper range of

These hazards pose risks to this operation, given depleted macroeconomic and social resilience. However, sustained reforms would help mitigate impacts and build climate resilience.

5. **The government has initiated a new phase of reforms to reduce macroeconomic imbalances and revive growth.** In the last 18 months, the government has reduced fuel subsidies, tightened monetary policy, partially eased FX surrender requirements, and continued SOE reforms to strengthen oversight and constrain their borrowing. In addition, a Capital Markets Authority, a new deposit insurance program, and a new digital ID system were established. The government has reiterated its commitment to liberalize key sectors of the economy (retail, wholesale, logistics). Responding to growing costs from climate change, Ethiopia committed to adaptation and mitigation measures by adopting a Long-Term Low Emissions Development Strategy (LT-LEDS).

6. **Ethiopia's development agenda remains vast, and its transition will take time.** The investment environment requires substantial reform to increase private sector entry and competition. Trade barriers remain significant. Ethiopia's trade-to-GDP ratio is the world's second lowest. It is not yet a World Trade Organization (WTO) member. Limited fiscal space has sharply reduced social and capital spending in real terms, and human capital levels remain low. A child born today will be 38 percent as productive as if she could enjoy a complete education and total health. SOEs remain inefficient, requiring bailouts, while regulatory privileges and a large footprint crowd out the private sector. Addressing these issues requires macroeconomic stability and various complementary structural reforms.

Relationship to CPF

7. **This DPO is aligned with the current CPF and consistent with emerging priorities of a forthcoming Ethiopia Country Partnership Framework (CPF, FY2025-30).** It also complements the World Bank Group's more comprehensive engagement portfolio in Ethiopia. Ethiopia has an IDA portfolio of US$ 17 billion in active projects, several of which support actions that complement the reforms supported by the DPO series. The current IDA portfolio includes operations in various sectors, including social safety nets, energy, finance, education, agriculture, land management, transport and trade logistics, water and sanitation, and urban development. A recently approved Power Sector Reform, Investment, and Modernization project (P176731) will support reforms in the energy sector. Moreover, a forthcoming Governance Modernization Project supporting revenue mobilization will help support and reinforce reforms supported by this DPO. A planned Financial Sector Strengthening Project (FSSP) will support financial sector governance and oversight modernization.

C. Proposed Development Objective(s)

To support the Government of Ethiopia's efforts to: (i) advance financial sector restructuring and trade liberalization; (ii) promote fiscal sustainability and transparency; and (iii) enhance social resilience and climate action.

Key Results

8. **This proposed DPO series supports the government in building foundations for more inclusive and sustainable growth.** Actions in this operation will help strengthen the financial sector, expand trading opportunities, increase fiscal transparency, efficiency, and sustainability, and enhance social resilience and climate action. These actions are expected to support Ethiopia in shifting towards a more inclusive and private sector-led growth model while also strengthening protections for poor and vulnerable households during periods of economic adjustment. It also aims to improve opportunities for growth from more pro-poor sources, especially agriculture and trade, which could benefit some of the

estimates, could push an additional 3.7 million people below the poverty line (Ethiopia Country Climate and Development Report 2024).

poorest people in Ethiopia.

D. Project Description

9. **This proposed Development Policy Operation (DPO) is the first in a programmatic series of two operations to support the Government of Ethiopia's efforts to (i) advance financial sector restructuring and trade liberalization, (ii) promote fiscal sustainability and transparency, and (iii) enhance social resilience and climate action.** It comprises an International Development Association (IDA) Grant and an IDA Credit totaling US$1.5 billion. It helps address market distortions and structural constraints undermining macroeconomic stability and inclusive private sector-led growth. This DPO is aligned with a forthcoming Country Partnership Framework (CPF, FY2025-30) and the 2024 Ethiopia Country Climate and Development Report (CCDR). Pillar 1 actions would increase financial intermediation and liberalize trade by strengthening the legal framework for banking supervision, increasing competition in the banking sector, and expanding trading opportunities. Pillar 2 actions would mobilize tax revenues, expand e-procurement services, support a transition to electricity cost-recovery, and enhance public sector financial transparency. Pillar 3 actions would cushion the poor from the impact of reforms by expanding and improving social safety nets, enhancing rural land and forest management regulations, and incorporating climate considerations in public investment, all of which will help build resilience and generate climate co-benefits.

10. **The proposed operation series is aligned with the goals of the Paris Agreement.** The program is consistent with Ethiopia's updated NDC, LT-LEDS, and CRGE commitments. Also, it aligns with CCDR recommendations to enable markets to work for a more carbon-efficient and climate-resilient economy. Although the operation does not directly support emission-intensive activities, banking and trade reforms that expand private investment and trade may increase GHG emissions. The operation is expected to reduce GHG emissions through (i) more sustainable land and forest management (which generate 90 percent of Ethiopia's carbon emissions); (ii) energy sector financial sustainability that will reduce wasteful consumption, sustain Ethiopia's low-carbon energy generation investment strategy, and enable faster access expansions to renewable-sourced grid and off-grid electricity that reduce energy emissions from carbon-emitting alternative energy sources (wood, charcoal, diesel). It will contribute to climate change priorities through safety net expansions, where 77 percent of all beneficiaries participate in public works programs directly linked to climate adaptation priorities. Other prior actions are not likely to increase Ethiopia's GHG emissions or restrict low-carbon development. Climate events, especially droughts, could affect the achievement of the PDO by reducing growth and increasing external financing needs. However, several prior actions (trade, safety nets, land reforms, green procurement, and ESIA) could reduce climate risks. Prior actions that do not contribute directly to adaptation but are not at risk from climate hazards include measures concerning the financial sector, energy tariffs, tax reform, and fiscal transparency. All prior actions are aligned with the mitigation, adaptation, and resilience goals of the Paris Agreement. Annex 6 provides a detailed review.

11. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as Prior Actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance mechanisms, or to the Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns. Project-affected communities and individuals may submit complaints to the Bank's independent Accountability Mechanism (AM). The AM houses the Inspection Panel, which determines whether harm occurred or could occur due to the Bank's non-compliance with its policies and procedures, and the Dispute Resolution Service, which provides communities and borrowers with the opportunity to address complaints through dispute resolution. Complaints may be submitted anytime after concerns have been brought directly to the World Bank's attention and Bank Management has been allowed to respond. For information on submitting complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the Bank's

Accountability Mechanism, please visit https://accountability.worldbank.org.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

12. **This operation is likely to generate some adverse poverty and social impacts.** Complementary reforms are not part of this operation, but supporting the underlying reform program will likely have short-term adverse poverty and social impacts. These impacts will be mitigated through expansions in social safety net assistance and the use of other budgetary programs to reduce impacts. Small negative or neutral effects on households' welfare are expected from actions relating to trade, domestic revenue mobilization, and the financial sustainability of the electricity sector. Trade and land management measures could also have positive poverty impacts due to expanded agricultural market opportunities and more secure land rights.

Environmental, Forests, and Other Natural Resource Aspects

13. **The prior actions supported by this DPF series are expected to have positive or neutral environmental impacts**. Measures will have direct and indirect benefits (e.g., land) through institutional reforms that strengthen the consideration of environmental and climate-related issues in public financial processes.

G. Risks and Mitigation

14. **There is a high risk that the Program Development Objectives may not be fully achieved.** Addressing Ethiopia's macroeconomic challenges will require sustained reforms over the medium term. Effective program implementation depends on a credible and market-reflective exchange rate, timely completion of debt negotiations with creditors, and bold measures to mitigate financial stability and fiscal risks from state banks and energy utilities. Administrative capacity constraints will pose a constraint. Mitigation measures include robust reforms to strengthen macroeconomic stability and reduce economic imbalances. These include support for achieving cost recovery in the energy sector over the medium term, improvements in revenue mobilization, enhanced financial sector oversight, and expansion of safety net programs, all of which are supported by this DPO series. The government is committed to macroeconomic stability, enabling more private sector participation, easing trade, pursuing prudent fiscal policies, moving to cost-reflective electricity tariffs, restructuring the energy and banking sectors, and improving the targeting and effectiveness of social safety nets. The programmatic nature of the DPO provides an opportunity for the World Bank to adapt to uncertainties as they emerge.

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APPROVAL

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